LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
MAY 15 1967

SUPREME COURT OF THE UNITED STATES

159

No. ~~1389~~

1967

B & L FARMS CO. and MAY SPACH, EDWIN L. HUBBARD and JOHN NICHOLAS, as Trustees in Bankruptcy for B & L Farms Co.,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

WILLIAM GRESHAM WARD
1240 duPont Building
Miami, Florida
Attorney for Petitioners

R. L. MERRIHALL, Inc., 926 Cherry Street, Kansas City, Mo. 64106, HArrison 1-2020

CITATIO.
JURISDIC
QUESTIO
STATUTE.
Copie
page
TIME

INDEX

...NS TO OPINIONS BELOW 2

...CTION 3

...ONS PRESENTED 3-15

...TES INVOLVED 16

...es of statutes and regulations referred to on ... 16 are attached as Appendix "D".)

STATE...NT 16-18

REASONS FOR GRANTING WRIT 18-22

ARGUMENT 22

General argument on reference to record and prior proceedings 22-26

Special argument with reference to payment doctrine under Section 162, Internal Revenue Code 26-30

Special argument on loss claimed on account of packing house and machinery (Section 165, Internal Revenue Code) 30-36

CONCLUSION 36-38

Index to Appendix

Appendix A—Opinion of United States Court of Appeals, Fifth Circuit A1

Appendix B—Order Denying Petition for Rehearing, U. S. Court of Appeals, Fifth Circuit .. A5

Appendix C—Opinion of Board of Tax Appeals, *Stuart* v. *Commissioner*, 38 B.T.A. 1147 ..... A16

Appendix D—Statutes and Regulations A17

Table of Authorities

CASES

B & L Farms Co., et al., as Trustees etc. v. *United States of America*, 238 F. Supp. 407 ..... 2, 3, 5, 6, 7, 8

Burnet v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 51 S. Ct. 262 31

Cline v. *Kaplan*, 323 U. S. 97, 65 S. Ct. 155 and 323 U. S. 691, 65 S. Ct. 67 19

Helvering, Commissioner, v. *Winnell*, 305 U. S. 79, 59 S. Ct. 45 33

Keller Street Development Co. v. *Commissioner*, (1963) 323 F. 2d 166 ..... 32, 34

B. J. Lake, Inc. v. *Commissioner of Internal Revenue*, (CCA 5) 148 F. 2d 898 6

John Nicholas, Trustee of the Estate of Beachcomber Motel, Inc., Bankrupt, 384 U.S. 678, 86 S. Ct. 1674 ..... 11, 19

Parkford v. *Commissioner*, 45 B. T. A. 461, 133 F. 2d 249 ..... 7, 8, 25

Rodeo-Vallejo Ferry Company v. *Commissioner*, 24 B. T. A. 936 ..... 31, 35

Gerald Segal v. *William J. Rochelle, Jr., Trustee*, 382 U.S. 375, 86 S. Ct. 511 29

Sexton v. *Dreyfus*, 219 U.S. 339, 31 S. Ct. 356, 55 L. Ed. 244 12

Stuart v. *Commissioner*, 38 B. T. A. 1147 ..... 6, 7, 20, 25

United States v. *Bradley*, (C.C.A. 5) 321 F. 2d 224 4

United States v. *Ohio Power Company*, 355 U.S. 98, 77 S. Ct. 652 20

United States v. *Wagner Electric Mfg. Co.*, (C.C.A. 9) 61 F. 2d 204 31

S. S. White Dental Manufacturing Co. v. *United States*, 55 F. Supp. 117 25-26

STATUTES

11 U.S.C., § 724, § 324, National Bankruptcy Act 4

11 U.S.C., § 707, ¶¶ 1 and 2 4

11 U.S.C.A., § 103, § 63, National Bankruptcy Act 10

11 U.S.C., § 799, § 307, National Bankruptcy Act 11

26 U.S.C., § 162 ..... 13, 23
26 U.S.C., § 165 13
28 U.S.C., § 1254(c) 18
Internal Revenue Code, 1954, § 172 16
National Bankruptcy Act, § 70(a)(5) 29

INTERNAL REVENUE REGULATIONS

Regulation 1.165-2(c) 14, 15
Regulation 39.23(e) 25, 26, 32
Regulation 1.165-2 34
Regulation 1.166-2, ¶ (c), sub ¶¶ (1) and (2) 37

TEXTS

Mertens on Taxation, Vol. IV, § 23.105 31

SUPREME COURT OF THE UNITED STATES

No. .....

B & L FARMS CO. and MAY SPACH, EDWIN L. HUBBARD and JOHN NICHOLAS, as Trustees in Bankruptcy for B & L Farms Co.,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable Earl C. Warren, Chief Justice of the Supreme Court of the United States, and the Associate Justices of the Supreme Court of the United States.

The petitioners, B & L FARMS CO. and MAY SPACH, EDWIN L. HUBBARD and JOHN NICHOLAS, as Trustees in Bankruptcy for B & L Farms Co., respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above cause on December 1st, 1966, on which a petition for rehearing, duly and timely filed,

was denied by opinion dated February 15th, 1967, and judgment was entered on February 15th, 1967, upon which the mandate of the United States Court of Appeals for the Fifth Circuit was issued on the 23rd day of February, 1967.

OPINIONS BELOW

The opinion of the United States District Court for the Southern District of Florida, dated the 15th day of June, 1964, is reported in *Federal Supplement, Volume 238, page 407*. Judgment on said opinion was filed July 30th, 1964. A petition for new trial and rehearing was filed timely (see Record, p. 59), and a new opinion and order on rehearing, dated February 19, 1965, is reported in 238 F. Supp. 407, and is also contained in the printed record at pages 41 through 55, both inclusive, and opinion and order on rehearing, beginning at page 79 of the printed record, through page 85.

The opinion of the United States Court of Appeals for the Fifth Circuit, dated December 1, 1966, is not yet reported in the Federal Reporter, Second Series, but a copy of said opinion is attached hereto as Appendix "A". A copy of said opinion is also attached to the printed record, certified by the Clerk of the United States Court of Appeals for the Fifth Circuit. The opinion of the United States Court of Appeals for the Fifth Circuit denying the petition for rehearing was filed February 15, 1967. A certified copy of said opinion is attached to the printed record, and a true copy is attached to this petition as Appendix "B". The judgment and mandate of the Court was entered on the 23rd day of February, 1967, a copy of the same being certified to as a part of the original record.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was made and entered on the 1st day of December, 1966, and recorded on December 1st, 1966, and a copy thereof as above referred to is attached to this petition as Appendix "A". The petition for rehearing was timely filed and that petition for rehearing was denied on February 15th, 1964, and final judgment of the Court and mandate was issued on the 23rd day of February, 1967, all shown in the Appendix attached hereto and above referred to.

The petition is filed timely (Title 28, U.S.C., § 2101 (c)). The jurisdiction of the Supreme Court of the United States is invoked under the provisions of Title 28, U.S.C., § 1254, as a certiorari from the final judgment or decree by the United States Court of Appeals for the Fifth Circuit.

QUESTIONS PRESENTED

The questions presented are duly and ably set forth in the opinion of the United States District Court for the Southern District of Florida, as reported in 238 F. Supp. 407.

B & L Farms Co., a Florida corporation, was incorporated in 1949. The corporation was engaged in the production and packing of tomatoes and other produce. The books and records from 1949 until 1954 were kept on a cash receipts and disbursements basis and the income tax of the company was reported on a fiscal year basis, commencing August 1st of each year and ending July 31st of the next year.

In compliance with the amendments relating to corporations in the 1954 Code, the main part of the books was continued to be kept on a cash receipts and disbursements basis, with certain limited items transferred to the accrual basis. As of August 1st, 1958, the beginning of the new fiscal year, a Chapter XI arrangement proceeding was filed by the corporation in the United States District Court for the Southern District of Florida (Pretrial Stipulation—R. 21).

The law in effect in 1959 (11 U.S.C., § 724; § 324 of the National Bankruptcy Act applicable to Chapter XI proceedings) required the filing of complete schedules. All creditors were required to be included and all debts, whether secured or unsecured, or whether liquidated or unliquidated, fixed or contingent, were required to be shown in the schedules (see 11 U.S.C., § 707, ¶¶ (1) and (2), also known as § 307, National Bankruptcy Act, ¶¶ (1) and (2)). The trade creditors required to be shown in the schedules as of August 1, 1958, included all of the trade creditors referred to in the opinion of the lower Court as being in the amount of approximately $2,459,-618.00.

As will be hereinafter pointed out, the petitioners contend that the book accounting and auditing arrangements, regardless of what they had been prior to August 1st, 1958, were transferred by operation of law to the accrual basis, and upon passing of the title to all of the assets, first to the Receiver in the Chapter XI proceedings and subsequently to the Trustees in Bankruptcy, in the same fiscal year payment was made on these debts which had been accrued by operation of law. The terms of the Bankruptcy Act would control in that instance over any of the provisions of the Internal Revenue Code or the regulations as to the technicality of accounting (*U. S.* v. *Bradley*, C.C.A. 5, 321 F. 2d 224).

In the operation under the plan of arrangement there were additional purchases from the trade creditors, and the farming operations continued but suffered additional losses. On June 26th, 1959, about five weeks before the close of the August 1st, 1958-July 31st, 1959 fiscal year, the company was adjudicated a bankrupt, and the individual Trustees, May Spach, Edwin L. Hubbard and John Nicholas, were appointed as Trustees in Bankruptcy for B & L Farms Co.

It is undisputed, as shown in the opinion of the lower Court, that there was the sum of $162,538.73, the amount which had been previously paid for income taxes, which was subject to adjustment and would have been applied as a net operating loss carry-back. A claim was made for refund after the claim had been denied by the Internal Revenue Service. Suit was then brought by the Trustees in the United States District Court for the Southern District of Florida.

The basis for the suit filed in the United States District Court is set forth in the opinion of the District Court, as shown in the reported decision in 238 F. Supp. 407 (see page 409, second column), as follows:

> "Plaintiffs contend that a larger net operating loss for fiscal year 1959 can be established, because of the transfer of all corporate assets to the trustees on June 26, 1959, by any one of the following deductions:
>
> (1) Deduction under 26 U.S.C., § 162 for business expenses due to the trade account indebtedness incurred during fiscal year 1959.
>
> (2) Deduction under 26 U.S.C., § 165 for a business loss because of the divestiture of the bankrupt's assets to the trustees.

(3) Deduction under 26 U.S.C., § 167 for a sudden obsolescence loss because of the abnormal retirement of the depreciable packing house and machinery at the time of the bankruptcy.

It is conceded that any one of these deductions, if valid, would be sufficient in amount to permit the refund claimed in this case."

As set forth in said opinion, the lower Court has analyzed these claims by separate discussion (see text, beginning page 409, 238 F. Supp. 407). The lower Court held against the Trustees' claims under Section 162, 26 U.S.C., because the corporation had been on a cash receipts and disbursements basis and the claims to the trade creditors were not actually paid or distributed to the creditors within the fiscal year ending July 31, 1959.

The lower Court relied upon the decision in the case of *B. J. Lake, Inc.* v. *Commissioner of Internal Revenue,* (C.C.A. 5) 148 F. 2d 898, wherein the Court construed the statute, then being 26 U.S.C.A., Internal Revenue Code, Section 24(c), as requiring an actual payment by a corporation to one of its officers within the calendar or fiscal year and within two and one-half months thereafter. Nothing was paid within two and one-half months after the end of the taxable year, but the taxpayer contended there was a constructive payment. The question now arises in the case at bar as to whether that case is controlling or whether the case of *Stuart* v. *Commissioner,* 38 B.T.A. 1147, which we contend is directly in point in favor of the Trustees, would control. The United States Court of Appeals, Fifth Circuit, in its opinion of December 1, 1966, now under review, by a two to one opinion affirmed the trial Judge without any opinion, but a dissenting opinion by Circuit Judge Brown clearly pointed out that the majority opinion affirming the lower Court was in

error because the effect of Section 70 of the Bankruptcy Act, 11 U.S.C.A., § 110(a), had been completely overlooked or ignored by the lower Court and by the majority of the United States Court of Appeals for the Fifth Circuit.

The United States Board of Tax Appeals in the case of *Stuart* v. *Commissioner*, supra, a copy of which is set forth in Appendix "C", as will be pointed out further in this petition, laid down certain principles of law and applied facts to that principle of law similar to the point before the Court, and if the holding of the Board of Tax Appeals in the Stuart case, supra, is the correct enunciation of the law, then the lower Court and the majority opinion of the United States Court of Appeals, Fifth Circuit, should be reversed. The doctrine of the B. J. Lake, Inc., case, supra, does not involve any intervening bankruptcy, and it is submitted by the petitioners that that case has no bearing upon the issues.

The first opinion of the lower Court (see 238 F. Supp. 407) made a brief comment concerning the Stuart v. Commissioner decision, supra, and recognized that the Stuart case was applicable, but it was merely the exception that proves the rule. However, the Court said (see text, p. 411), that the principle in the Stuart case was later rejected in *Parkford* v. *Commissioner*, 45 B.T.A. 461, affirmed 133 F. 2d 249, 9th Cir., 1943. On petition for rehearing in the lower Court, which was granted (see text, p. 414 of 238 F. Supp. 407), the trial Judge elaborated upon the Stuart case, but the Court in disposing of the Stuart case said that it was of the opinion that the Stuart case was directly contrary to the overwhelming weight of authority of said point as previously cited by the Court, and the Court declined to follow the Stuart case.

The question now presented for decision by this Court is whether the doctrine of the Stuart case is still the law. The petitioners contend that the law enunciated in that case has never been rejected and that it is applicable to the case at bar. When all of the assets were turned over within the fiscal year August 1, 1958 to July 31, 1959, that constituted a payment to the extent as was subsequently determined and it all occurred within the same taxable fiscal year. The lower Court, as shown by the language in the opinion in 238 F. Supp. 407 (text, p. 409, second column), clearly did not understand the contention of the petitioners, nor did it clearly understand the difference between the Stuart case and the Parkford case. Just prior to that Court's portion of the opinion the Court had analyzed the Stuart case and recognized that that case was authority for the proposition that when a cash basis taxpayer who had a judgment entered against him in 1933, went into bankruptcy in 1934, the taxpayer was entitled to a business loss deduction for the tax year of 1934, because all of his assets passed by operation of law to the trustee in turn for payment to the creditors. The Court did misconstrue the theory of this case by saying that the fact that there was only one creditor who held a judgment brought about a different conclusion than if there had been several creditors. The Court also said that that case was authority that there would be a trade expense as being paid for purposes of Section 162 in the year 1934, even though the creditors were not actually paid within that fiscal or calendar year. That is what the petitioners contend is the applicable law in the case at bar.

However, the lower Court was confused about the holding in the case of *Parkford* v. *Commissioner*, 45 B.T.A. 461, affirmed 133 F. 2d 249, because that decision did not have any bearing upon the doctrine of the Stuart case.

The gist of the Parkford case is that the taxpayer, an individual, was nevertheless on an accrual basis. The taxpayer made his tax returns based upon an accrual basis. Since he had adopted the accrual basis and had accrued his debts as against his income there were no deductible debts at the time of bankruptcy. He would have received his tax deductions prior to bankruptcy for any deductible debts or expenses theretofore incurred. Obviously he had no deductible loss at bankruptcy when he parted with his property to pay debts for which he had already received a deduction. Under Section 162, in the case at bar, when these accounts had been accrued by operation of law, the ultimate net value of the distributable estate was paid to or passed to the Trustees in Bankruptcy on June 26, 1959, and under the provisions of Section 70 of the Bankruptcy Act not only possession but title passed to the Trustees in Bankruptcy. This was not a contingent payment. This was not a substitute type of payment. As Judge Brown in the dissenting opinion of December 1, 1966, held, this was a direct payment, unconditional and subject only to the time which it took in the Bankruptcy Court to make the ultimate distribution to the creditors.

The Government has admitted all of the factual matters as set forth in the pretrial stipulation, and we say implicitly it was stipulated by the Government that if the Trustees had been able to make the distribution to the creditors within the five weeks still remaining in the 1959 fiscal year, this would have constituted the payment and, therefore, an expense and that the loss could be carried back to 1956. Actually the sole question as we construe it on behalf of the petitioners is who is charged with the necessary and consequent delay in the liquidation and payment to the actual creditors.

The lower Court and two of the members of the panel of the Appellate Court said that the payment was not made by July 31, 1959, or within the same fiscal year. Judge Brown, as the author of the dissenting opinion, says that it was. In our opinion this is a question that has not ever been definitely decided by any Court on the level of the Tax Court or of the Federal Appellate Courts or this Court, with the exception of the definite holding by the Tax Court at the time when it was entitled "Board of Tax Appeals" in the Stuart case, supra. This is an important question of the construction of the federal laws covering taxes, as well as an important and unsolved question in the administration of the National Bankruptcy Act, over which this Court has supervisory jurisdiction to the end that the administration of the National Bankruptcy Act shall be uniform throughout the country.

Judge Brown pointed out in the dissenting opinion that under Section 63 of the Bankruptcy Act, 11 U.S.C.A., § 103, all claims are matured under date of the bankruptcy, and that at the instant of bankruptcy the title to the assets vests in the trustee, in trust for the creditors, pro rata according to the debts held by them as of that same instant. It is pointed out that the payment doctrine, as recognized by the District Court in its opinion, was met when the payment was in cash, or its equivalent in property.

There still remains a question which has not been definitely settled, even under the dissenting opinion, as to the effect of the filing of the Chapter XI proceeding on the first day of the new fiscal year, August 1, 1958. None of the Courts' opinions that we have been able to find have ever passed squarely upon the effect of a Chapter XI petition being filed, and as to whether Section 63(a) of the Bankruptcy Act, 11 U.S.C.A., which matures all of

the debts of a bankrupt on the date of the bankruptcy, applies equally to a Chapter XI arrangement proceeding. The petitioners have submitted that question for determination both in the lower Court and in the Appellate Court. Under the provisions of Chapter XI (Arrangements), U.S.C., Title 11, Chapter 11, Section 799, the very first two provisions, Sections 301 and 302, the provisions of Section 63 of the Bankruptcy Act are applicable because of a special insertion in the Chapter XI features. Under Section 307, paragraph (1), it is provided:

> "(1) 'creditors' shall include the holders of all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 63 of this Act and whether liquidated or unliquidated, fixed or contingent."

This Court in the case of *John Nicholas, Trustee of the Estate of Beachcomber Motel, Inc., Bankrupt,* 384 U.S. 678, 86 S. Ct. 1674, decided June 13, 1966, passed upon a set of facts of a similar type involved in this case. It appears that on August 6, 1958, Beachcomber Motel, Inc., a Florida corporation, filed an original petition for an arrangement with its unsecured creditors under Chapter XI, Bankruptcy Act, § 322, 11 U.S.C., § 722. After the operation by the debtor in possession for a short time the arrangement failed and an adjudication in bankruptcy ensued. In the body of that opinion, and we quote from 86 S. Ct. 1674, text 1679, second column, the Court said:

> "We believe that the decisions of this Court in *Sexton* and *Saper*, reflect the broad equitable principle that creditors should not be disadvantaged *vis-a-vis* one another by legal delays attributable solely to the time-consuming procedures inherent in the administration of the bankruptcy laws."

In note 11 referred to in said opinion, this Court quoted with approval from the opinion of this Court in

Sexton v. *Dreyfus*, 219 U.S. 339, 31 S. Ct. 356, 55 L. Ed. 244, as follows:

> " 'The rule is not unreasonable when closely considered. It simply fixes the moment when the affairs of the bankrupt are supposed to be wound up. If, as in a well known illustration of Chief Justice Shaw's Parks v. City of Boston, 15 Pick. 198, 208, the whole matter could be settled in a day by a pie-powder court, the secured creditor would be called upon to sell or have his security valued on the spot, would receive a dividend upon that footing, would suffer no injustice, and could not complain.' "

The question now arises as to whether under the principles laid down in the Nicholas case, supra, the payment of the creditors as a matter of law was timed or fixed as the date of the adjudication in bankruptcy, June 26, 1959, regardless of how long it took the Trustees in Bankruptcy to liquidate and pay each creditor his proportionate dividend. If this Court should apply the same doctrine in the case at bar as it enunciated in the Nicholas case, then clearly the lower Court in the case at bar and the majority opinion of the United States Court of Appeals, Fifth Circuit, was clearly erroneous, and the opinion expressed by Judge Brown in the dissenting opinion should be the law applicable. While Judge Brown in his dissenting opinion recognized the impact of the filing of a Chapter XI proceeding, he did not clearly rule that as of August 1, 1958, the corporate affairs were automatically under an accrual basis as to the unpaid open accounts when they came into the hands of the Trustees in Bankruptcy on June 26, 1959. Judge Brown simply consolidated both of these factors in holding that the combination of circumstances and the effect of Section 70 was to amount to a payment pro tanto of the creditors.

The above statements of the questions involved as presented are all directed towards the claim deductions under 26 U.S.C., § 162. Further questions are presented under the second theory of claim for deduction under 26 U.S.C., § 165, for a business loss because of the divesture of the bankrupt's assets to the Trustees. The lower Court in its first opinion, 238 F. Supp. 407, at page 411, analyzed the second claim under Section 165, and in substance said that it could not recognize the applicability of Section 165 as being in any essential way different from its claim under Section 162. The essential feature of Section 165 provides in part:

> "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."

The lower Court could not see any distinction between the two claims—one, the loss under Section 162, and the other, the loss under Section 165, because the Court completely overlooked sub-section (b) of Section 165 of the Internal Revenue Code of 1954, which is as follows:

> "(b) For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property."

Section 1011 of the Code referred to in sub-section (b), in effect provides that the taxpayer for this deduction can claim no more than the undepreciated portion of the asset, that is, the deduction is decreased by the depreciation previously taken and the salvage value of the asset. In the instant case the packing house and its machinery were singled out and the undepreciated cost claimed as a deduction because the unrecoverable cost

of the packing house and the packing house machinery was $457,735.00. This was computed by the unrecovered depreciable cost at the time of adjudication of the sum of $720,735.00 and the salvage value was stipulated to be $263,000.00, leaving a stipulated deductible remainder of $457,735.00, which in itself was more than enough if allowed as a deduction to effect recovery of the amount claimed. These amounts were stipulated in the pretrial stipulation (see Record, page 23).

Petitioners state that the question is presented as to whether under the provisions of Section 165, sub-sections (a) and (b), the Petitioners are entitled to a deductible loss in the amount above stated, and whether the District Court's order and that part of the order of the United States Court of Appeals, Fifth Circuit, was erroneous in the failure to recognize the loss under said Section 165.

In the petition for rehearing, which was directed to the opinion and judgment of the lower Court in the first opinion, as reflected and shown in the Transcript of the Record at page 56 (see actual discussion of the loss deduction under Section 165, beginning on page 69 of the Record), the Petitioners set forth that the reason for including a claim both under Section 165 and Section 167 was because of a confusion in Regulation 1.165-2(c), which reads as follows:

> "*Cross References.* For the allowance under Section 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see § 1.167(a)-8. For provisions respecting the obsolescence of depreciable property, see § 1.167(a)-9. For the allowance of casualty losses, see § 1.165-7."

Because of the confusion in the regulations Petitioners in the Court below claimed that the losses would be

covered both under Sections 165 and 167, but the claim under Section 167 was abandoned on the appeal to the United States Court of Appeals, Fifth Circuit, under the claim that it was fully covered under Section 165, and that Petitioners were entitled to the construction and regulations that had been carried for many years under the similar code provision of the 1939 Code and temporary Regulations 39.23(e).

In its opinion on the petition for rehearing (see 238 F. Supp. 407, second column, page 414, and first column, page 415), in clarifying the first opinion the lower Court conceded that the regulation covering the construction of Section 165 would be the same as Regulation 39.23(e) of the 1939 Code, and said:

> "The regulation should not be interpreted to permit a 'loss' deduction simply because the taxpayer has physically given up its property.
>
> The question is always present under section 165 as to what was obtained in return for giving up any property. In the present case, liquidation of liabilities was obtained by the disposition of the property by the bankruptcy trustee. This was not a 'loss' and no deduction is authorized."

All of the three Judges sitting on the panel of the United States Court of Appeals for the Fifth Circuit affirmed the District Judge in this conclusion on the applicability of Section 165, and, therefore, the additional question is presented as to whether there was an erroneous ruling of law in the construction of the federal statute and the tax regulations applicable thereto.

STATUTES INVOLVED

Section 63 of the National Bankruptcy Act, 11 U.S.C., § 103; Section 70 of the National Bankruptcy Act, 11 U.S.C., § 110; Sections 301 and 302 of the National Bankruptcy Act, 11 U.S.C., §§ 701, 702; Section 307 of the National Bankruptcy Act, 11 U.S.C., § 707; 26 U.S.C., § 162; 26 U.S.C., § 165; Section 172, I.R.C., 1954; I.R.S. Temporary Regulation 39.23(e). Attached to this petition as Appendix "D", beginning at page A17, all of these statutes and regulations are set forth in full.

STATEMENT

Despite the fact that it has been through the throes of bankruptcy, B & L Farms Co. was at one time a very profitable operation. For its fiscal year ending July 31, 1955, after various adjustments were made, it paid a total income tax of $1,013,508 (R. 22). For its fiscal year ending July 31, 1956, after adjustments, it paid a total of $162,538.73 (R. 22), which is sought to be recovered here. The company had no earnings after the end of its year 1956 (R. 22), and, as a result of a freeze occurring during the Winter crop year of 1957-58, B & L Farms Co.'s operations for the year ending July 31, 1958, showed liabilities of $3,000,000.00, of which approximately 2.5 million was for deductible operating expenses (R. 29, 30), which, because the company was on a cash basis (R. 21), had not been accrued on the books of the company and could not be carried back against the tax of $1,013,508.00 paid for the fiscal year ending July 31, 1955. In the face of this insurmountable operating loss, on August 1, 1958 (which was the beginning of the fiscal year in which the adjudication occurred), B & L Farms Co. filed a petition under Chapter XI of the Bankruptcy Act whereby it proposed

to pay creditors in full (R. 21). A receiver was appointed to operate the company; however, the odds were apparently against success, and on petition of several of the creditors, the corporation was adjudicated a bankrupt on June 26, 1959. Trustees in Bankruptcy were appointed on that date by the Referee in Bankruptcy with instructions to liquidate the corporation (R. 21). The facts show that the assets turned over to the Trustees in Bankruptcy will pay little, if any, more than 50% of the claims of unsecured creditors, which claims are made up of the $3,000,000.00 in liabilities for which the corporation was obligated at the end of its fiscal year ending in 1958 (R. 24, 25). As stated before, 2.5 million of this 3 million in liabilities was for operating expenses not previously deducted.

Of the depreciable assets of the bankrupt corporation, at the time of the bankruptcy, was a packing house with machinery, the total unrecovered depreciable cost of which, after depreciation was taken, was $720,735.00 (R. 23). At the time of the adjudication, the salvage value of this asset was $264,000.00 (R. 31), leaving an unrecovered difference of $456,735.00 which is undisputedly a loss. The Stipulation of Facts entered into between the parties shows that upon adjudication, the farming operations of the company were terminated and that the packing house and machinery were not operated by the trustees (R. 21, 23).

For its fiscal year ending July 31, 1956, the corporation made a profit and after various audits and adjustments for subsequent losses, a total tax liability of $162,538.73 was determined. This tax was paid and no part of this amount has been refunded the taxpayer (R. 22).

As the tax burden has increased Congress has, in the case of business operations, given the taxpayer a measure of relief by not requiring him to compartmentalize a busi-

ness operating loss in one taxable year, but under § 172 (b) of the 1954 I.R.C., has authorized the taxpayer to carry back a loss to each of the three taxable years preceding the year of the loss, and if not used up in these three years, then to carry the loss forward for five taxable years. Since 1956 was the last year in which B & L Farms had taxable earnings, the losses occurring in the fiscal year ending in 1959 are important in that they are the last losses which can be carried back. It should be noted here that the figures of $162,538.73, taxes paid in the year 1956, is after adjustment for carry back losses which the Government ceded. What the taxpayer seeks to do here is establish that it had additional deductions which, when allowed in the year ending in 1959, result in a net operating loss for that year far in excess of $312,574.00, the amount of adjusted profit for the year ending 1956, upon which final assessment of taxes was made by the Internal Revenue Service. These deductions, when attributed to 1959 operations create losses, which when carried back to 1956 result in the taxpayer being entitled to a refund of its entire tax liability for that year. Fundamentally the Government does not dispute the fact that if the deductions are allowable in the year 1959, Plaintiffs' established losses would result in recovery of the entire tax liability. The Defendant's prime contention is that the loss did not occur during the 1959 fiscal year.

REASONS FOR GRANTING THE WRIT

Under *Title 28, U.S.C., Section 1254*, the Supreme Court of the United States is authorized to review by writ of certiorari any civil or criminal case in any United States Court of Appeal before or after rendition of judgment or decree. From a technical viewpoint this case is not a petition for certiorari from direct proceedings in a Bank-

ruptcy Court, but it is of interest to note in bankruptcy matters, under *Title 11, U.S.C.*, § *24(c)*, it is provided:

> "The Supreme Court of the United States is hereby vested with jurisdiction to review judgments, decrees, and orders of the United States courts of appeals in proceedings under this Act in accordance with the provisions of the laws of the United States now in force or such as may hereafter be enacted."

This Court has long adopted the policy in bankruptcy cases of supervising the uniform operation of the bankruptcy laws to end conflicts, and this power is not limited solely to the question where it appears that the only conflicts are in the various opinions of the United States Courts of Appeal. See the case of *Cline* v. *Kaplan*, 323 U.S. 97, 65 S. Ct. 155, and reference made in said case to the prior opinion of the Court where certiorari was granted, 323 U.S. 691, 65 S. Ct. 67, where the Court said:

> "Conflicting views having been expressed in different circuits on matters affecting bankruptcy administration which ought not to be left in doubt, we granted certiorari."

This Court has uniformly granted certiorari in its position as the supervisor of the bankruptcy laws, which is not limited entirely to where the question of the conflict is between two United States Courts of Appeal. This is further emphasized by the opinion of this Court in the case of *John Nicholas, Trustee of the Estate of Beachcomber Motel, Inc., Bankrupt*, 384 U.S. 678, 86 S. Ct. 1674. It is true that in that case this Court took jurisdiction of a bankruptcy matter reviewing certain tax statutes of the United States as to the liability of the trustee, and there was apparently a conflict between the United States Court of Appeals for the Fifth Circuit and the United States Court of Appeals for the Eighth Circuit, yet this

Court having taken jurisdiction reviewed the statutes of the United States relating to taxation. Whether this was done solely because of the conflict between two United States Courts of Appeal or whether it was for the purpose of acting in a supervisory capacity for the benefit of uniform construction of the bankruptcy law is not too clear from the opinion. However, we say that the same principles are involved, although not strictly in a bankruptcy proceeding.

In the case of *United States* v. *Ohio Power Company*, 355 U.S. 98, 77 S. Ct. 652, this Court had previously denied certiorari concerning the construction of a tax statute of the United States Internal Revenue Code. A petition for rehearing was also denied, but after the time period of the rules had expired this Court recalled its opinion of denial of the certiorari in the interest of justice and for the purpose of having uniformity in the construction of the Internal Revenue Code of the United States.

In the case at bar the Board of Tax Appeals in the case of *Stuart* v. *Commissioner*, 38 B.T.A. 1147, a copy of the opinion in said case being attached hereto as Appendix "C", squarely passed upon the same situation under the tax statutes as is involved in this case. There has been no opinion so far as we can find by any prior opinion of the United States Court of Appeals, or by this Court, which has ever, directly or indirectly, rejected the rule in the Stuart case, supra, until the decision of the United States District Judge, Southern District of Florida, in this case in the opinion reported in 238 F. Supp. 407.

The Stuart case was the law of the Board of Tax Appeals and the subsequent Tax Court of the United States, and it stood unchallenged for many years. It is the contention of the petitioners that when this tax controversy

arose in 1959 that decision of the Board of Tax Appeals (U. S. Tax Court) was not only persuasive, but was binding upon the Commissioner of Internal Revenue where there had been no substantial changes in the United States Tax Code or in the regulations. We have not been favored with any specific citations presented by the United States or by the United States District Court, or even by the majority opinion of the United States Court of Appeals for the Fifth Circuit, which would justify the legal conclusions reached by the United States District Court or the United States Court of Appeals for the Fifth Circuit in the majority opinion. The dissenting opinion by Judge Brown discloses that there are no opinions that had been brought to his attention when he reached the conclusion in the dissenting opinion that the petitioners' claim on behalf of the creditors of the bankrupt estate was well founded.

In a sense this is a case of first impression, with the exception of the decision in the Stuart case in the Board of Tax Appeals. This is a controversy that will necessarily arise in many bankruptcy cases. We, therefore, submit that the principles of law on the following questions have not ever been definitely determined, with the exception of the rule laid down in the Stuart case which was favorable to and supports the claim of the petitioners. The effect of the opinion in this case both by the United States District Court, Southern District of Florida, and the United States Court of Appeals for the Fifth Circuit, leaves undecided the following questions of law:

> Where a cash basis taxpayer is adjudicated a bankrupt, the transfer of its assets to a trustee in bankruptcy operates to give the bankrupt a tax deduction in the year of adjudication to the extent of the taxpayer's undeducted operating expenses for either of the following three reasons:

(A) Under the Bankruptcy Act, a bankrupt keeping its books on a cash receipts and disbursements method of accounting is required to close its books of account as of the date of adjudication in bankruptcy and as of that date by operation of law is transferred to an accrual method of accounting, or

(B) The unconditional transfer of assets from the bankrupt to the trustees in bankruptcy constitutes payment by the bankrupt for theretofore undeducted deductible expenses, or

(C) Divestment of all of the taxpayer's business property for the payment of deductible operating expenses by an adjudication in bankruptcy and appointment of trustees entitled the taxpayer to a deduction under § 165 of the Internal Revenue Code.

Regardless of whether a conflict between the United States Court of Appeals decision and the decision of the Board of Tax Appeals of the United States (U. S. Tax Court) would not of itself justify this Court to take jurisdiction on certiorari, this case does present an important and far-reaching federal question of the construction of Sections 162 and 165, United States Internal Revenue Code of 1954 as amended, as to its application generally, as well as in bankruptcy matters. A review by this Court is essential not only in the interest of justice, but for the purpose of protecting and establishing a uniformity of construction.

ARGUMENT

The petitioners present a very limited argument in this portion of the petition for certiorari, because in view of the record a lengthy argument would be pure repetition.

The record submitted to the Appellate Court consisted of 89 printed pages and only the opinion of the Court and petition for rehearing and orders thereon have been added by the Clerk, so that the entire record is comparatively small. We have produced and filed with this Court one certified copy of the printed record and nine additional copies.

A reference to the record discloses that a simplified pretrial stipulation was entered into between the parties (R. 20). The items shown from page 20 to the top of page 24 are all stipulated and much of the factual background which is carried in the opinion of the lower Court (238 F. Supp. 407) is taken from that stipulation. Beginning on page 24 of the record there are allegations of factual matters which the petitioners relied upon, but which had not been agreed upon by the Government. However, the findings of the lower Court established those factual matters and it was finally determined that the Trustees on June 26, 1959, received approximately $200,000.00 in cash, and that the salvage value of the packing house and machinery did not exceed the sum of $263,000.00.

In the said stipulation (R. 26) the position of the plaintiffs below, the petitioners herein, was analyzed, but the basis of the defense for the Government was not clearly set forth. This pretrial stipulation was amended (R. 29) and the actual factual matters which had been submitted by the plaintiffs in the first stipulation were agreed to by the Government, as reflected on pages 29 through 31 of the record. This stipulation, as shown in the record beginning at page 31, specifically set up the defendant's objections to the claim. The first objection was directed to the claim under Section 162, 26 U.S.C. The Government simply contended that although these trade accounts payable amounting to $2,459,618.00 were due and owing, since the corporation had not paid those

accounts and since the corporation was on a cash receipts and disbursements basis, they could not be used in computing losses which would give rise to deductions. The Government further contended that "prior to adjudication in bankruptcy, these trade accounts were not recorded as liabilities on the Company's books and are not reflected in the computation of capital and surplus stated in Paragraph IV(e) of the Pre-Trial Stipulation". It was admitted that the amount of the actual operating accounts, referred to as the trade creditors, represented 82% of all of the unsecured claims. There was no dispute about the actual amount of the losses either under Section 162 or Section 165. However, with reference to the losses claimed under Section 165 or 167 the Government made the additional claim by way of defense that a transfer by operation of law at the time of bankruptcy, even though there was an admitted fact of loss over and above the depreciation factors, did not give rise to a deductible debt for income tax purposes.

The last two paragraphs of the pretrial stipulation (R. 32) sum up the issues, and we quote:

> "Even if the taxpayer suffered a loss by going into bankruptcy, it is not the type of loss contemplated by § 172 of the 1954 Code which may be carried back and applied against prior years' income.
>
> VIII. The parties hereby agree that, should the Court determine the issues presented in favor of the plaintiffs, the parties will agree upon a computation of the amount of taxes and interest refundable and present the computation for the entry of Judgment."

The opinion of the District Court, filed June 25, 1964, and reported in 238 F. Supp. 407, is carried in full in the record beginning at page 41 through page 55.

When this opinion and the subsequent judgment was entered on that opinion, the judgment being shown in the record at page 55, the plaintiffs below, the petitioners herein, filed a comprehensive motion for new trial, rehearing and to alter or amend judgment and opinion (R. 56-78). In that motion numerous authorities were set forth, to which we refer rather than to extend the argument in this petition by a mere repetitious submission of extensive authorities.

Beginning on page 66 of the record the plaintiffs below, the petitioners herein, thoroughly discussed the "payment theory" and losses claimed under Section 162. On page 69 of the record there is reflected the analysis of authorities under the loss claimed under Section 165. Extensive quotations from the case of *Stuart* v. *Commissioner*, 38 B.T.A. 1147, were set forth, as shown in the record on pages 70, 71 and 72.

In the record on page 73 the Court will find a discussion and analysis of the case of *Parkford* v. *Commissioner*, 45 B.T.A. 46, affirmed 133 F. 2d 249, and it was pointed out that the Parkford case, which was relied upon by the lower Court as overruling the doctrine in the Stuart case, was not applicable.

Beginning on page 74 of the record the Court will find the analysis of the loss claimed under Section 165, which is based upon a loss measured by the difference between the unrecovered depreciable cost of the property and its salvage value. It was particularly pointed out that Section 165 of the 1954 Code was not covered by any new regulation in 1959, but that the temporary regulation, 39.23(e), was the controlling regulation. It was pointed out that this same situation had been passed upon by the Court of Claims in the case of *S. S. White Dental Manu-*

facturing Co. v. *United States,* 55 F. Supp. 117, which sustained the same position claimed by the petitioners. Regulation 39.23(e) was referred to and provides in part as follows:

> "*Loss of Useful Value.* When through some change in business conditions, the usefulness in business of some or all of the capital assets is suddenly terminated so that the taxpayer *discontinues the business or discards such assets permanently from use in such business,* he may claim a loss for the year in which he takes such action * * *."

In the second opinion by the lower Court (R. 79) the Court did recognize that Regulation 39.23(e) under the 1939 Code might sustain the position of the petitioners, but nevertheless it held that even under Regulation 39.23 (e), and assuming it was applicable, the plaintiffs below had not established the loss of useful value by proving "some objective loss of value has occurred, and which loss of value has caused the discarding of the property".

Special Argument with Reference to "Payment Doctrine" under Section 162

Some confusion has arisen in the treatment of the question as to whether the claim of the petitioners under Section 162 should be allowed. The dissenting opinion of Judge Brown, a copy of which is made a part of the appendix hereto, and which is also certified in the record, is a short but thorough analysis of the position of the petitioners in that regard. There is no dispute about the merits of that claim or the fact that these debts were due and owing. The dissenting opinion makes reference to the previous Chapter XI proceeding which was filed on the first day of the new fiscal year, August 1, 1958, to and including July 31, 1959.

Under the stipulation of counsel and under the admitted facts in the case there was an arrangement proceeding. All of the title to the assets passed to either the debtor in possession under Chapter XI, or into such receiver or trustee as the Court might appoint. The debtor was not left in possession, but a receiver was appointed. All debts owing by the corporation became due and payable forthwith. All accounts payable, which included some $3,000,000.00, of which 82% represented the trade creditors, became accrued and due and payable. A Chapter XI proceeding, as we have heretofore pointed out, works two ways. It not only accrues all debts of the corporation whether on the books or not, but it also accrues all assets or accounts receivable whether due or not, as long as they are in the class of a general creditor.

The Government's position is that after the Chapter XI proceeding was filed, and even admitting that the accounts of creditors of the corporation became due and payable forthwith, the accounts payable for these trade creditors did not simultaneously become accrued. We say that position is untenable under the established law as set forth in the Chapter XI bankruptcy proceedings. All receiverships or trusteeships, whether they be under state laws or federal laws, or even in probate proceedings, are controlled by accruals and all accounts are mutually due and payable regardless of what type of accounting had been practiced by the taxpayer prior thereto. Many other provisions of the Bankruptcy Act, including the right of set-off, would be utterly voided if this were not the case. The operation of the receiver or trustee is a necessity on an accrual basis. Otherwise no plan or arrangement or even liquidation could be entertained. Suppose, for example, the receiver who had title to the assets under the Chapter XI proceeding and who was operating the busi-

ness elected to sell the assets, either partially or entirely, and applied the proceeds to the payment of the debts. Could it be argued successfully by the Government that the receiver or trustee under a Chapter XI proceeding would not have to prorate those payments to all of the creditors, including the trade creditors? If this had been done during the Chapter XI proceedings and if the Chapter XI proceedings had continued for the full 1958-1959 fiscal year, there is no question but what the losses would have been allowed and the Chapter XI trustee or receiver would have had a right to go back to the 1956 fund and claim a refund.

The United States District Court had complete jurisdiction of the assets. It could have ordered partial liquidation and partial payment on all of the unsecured creditors pro rata, and even without any sale of property certainly the $200,000.00 in cash could have been applied. If the packing house and machinery had been disposed of during the Chapter XI proceedings, the losses contemplated under Section 165 would have been allowed and the receiver or trustee in Chapter XI would have been entitled to the refund claim. When the bankruptcy procedure was instigated on the application of certain of the creditors and the adjudication was entered on June 26, 1959, within five weeks of the end of the same fiscal year, why was there any different legal situation involved? One distinct feature of the bankruptcy adjudication was the simultaneous order to stop the operation of the business and to liquidate. Let us suppose for the sake of argument that the bankruptcy adjudication had taken place in February or March, 1959 instead of June 26, 1959, and the Trustees in Bankruptcy had liquidated and made partial distribution to creditors before the end of the 1958-1959 fiscal year. Certainly the Government could not contend there had been no payment made to

creditors. We propose another example—suppose on June 26, 1959, or several days thereafter, the $200,000.00 in cash was ordered by the federal Court to be distributed pro rata to those creditors. That would have been a simple way, because all of the accounts had been settled and that was possible. Just because the necessary procedures of delay in bankruptcy prevented the Trustees in Bankruptcy from moving fast enough to make partial liquidation within the five weeks before the end of the fiscal year, why should the innocent general creditors be penalized? The bankrupt corporation had thrown all of its assets by operation of law into the bankruptcy and if the date of the bankruptcy is the controlling date, payment pro tanto or pro rata had been made for the value not only of the cash passed, but of the property.

Admittedly in 1959, there was some question as to whether refunds for loss carry-backs actually passed to the Trustees and the uncertainty about that law may have been one of the factors that influenced the lower Court, because special comment is made by the lower Court in the first opinion (R. 54) wherein the Court expressed the idea that the title to these refund claims did not go to the Trustees. However, any question in that regard was settled by this Court in the case of *Gerald Segal* v. *William J. Rochelle, Jr., Trustee,* 382 U.S. 375, 86 S. Ct. 511, opinion dated January 18, 1966. This Court definitely held that because of conflicts in other Court of Appeals decisions these claims for refunds actually passed to the trustee. Judge Brown, in the dissenting opinion of December 1, 1966, and perhaps being influenced by this most recent decision of this Court on the subject pointed out that the majority opinion had failed to give the proper construction to Section 70(a)(5). The majority opinion in the December 1, 1966 decision, as pointed out by Judge Brown,

is directly in conflict with the opinion of this Court in the Segal case, supra. We think it would be sufficient only to say with reference to the claim under Section 162 that if the majority of the Court had even considered the Segal opinion, supra, and given it the weight to which it was entitled, Judge Brown's dissenting opinion would have been the majority opinion of the Court. If this doctrine of the Segal case had been properly applied and the doctrine of the opinion of this Court in the Nicholas case, supra, had been properly applied, then certainly the opinion of the majority was wrong.

Loss Claimed on Account of Packing House and Machinery

The Government's position with reference to the above item and as adopted by the lower Court and the majority opinion of the Appellate Court is based upon the contention that the identifiable event or, as expressed by the opinion of the lower Court, objective loss, must either be a sale of the assets or physical abandonment thereof where it can not or will not be retrieved for any salvage value. We say this is not the law.

Petitioners' contention is that there was a change in business conditions which suddenly caused the permanent discontinuance of the taxpayer's business and the usefulness of the packing house and its machinery in its business, whereby it suffered a large loss. The forced discontinuance of the business caused by economic forces beyond its control, is the identifiable event which fixed the year of the loss deduction.

Obsolescence has been classified by the Commissioner into separate categories, namely, "normal" and "extraordinary or special". Normal obsolescence according to his classification is to cover a situation where obsolescence

becomes predictable in a year prior to the termination of its usefulness. This has the effect of treating "normal" obsolescence as a part of the depreciation and deductible under § 167 of the Code. Since "extra or special obsolescence" has been defined as a sudden loss of usefulness which usually cannot be predicted before it actually occurs, it partakes of a loss which usually occurs in one year and recovery was authorized by regulation under the loss statute, § 165 of the Code. (*Mertens on Taxation,* Vol. IV, § 23.105). This classification has caused considerable confusion.

It has long been held discontinuance of a business caused by forces beyond the control of the taxpayer gives rise to an obsolescence deduction. There are many cases under the prohibition law which caused the discontinuance of business engaged in the manufacture and sale of intoxicating liquors. In *Burnet* v. *Niagara Falls Brewing Co.,* 282 U.S. 648, 51 S. Ct. 262, the Supreme Court held that the imminence of prohibition was foreseeable in January, 1918, and took effect in January, 1920, and a taxpayer could spread his loss (book value less salvage value) over that period. In *Rodeo-Vallejo Ferry Company* v. *Commissioner,* 24 B.T.A. 936, the court held that where the building of a bridge would cause a discontinuance of its business, the loss (book value less salvage value) could be spread over the period from the beginning to completion of the bridge. In *United States* v. *Wagner Electric Mfg. Co.,* (C.C.A. 9, 1932) 61 F. 2d 204, a large obsolescence loss of a shell making plant and machinery was allowed due to termination of the First World War, part in the year 1918 and 1919, when the manufacture of shells would cease. The court stated:

> "There is no hard and fast rule as suggested by the government, that a taxpayer must show his prop-

erty will be scrapped or cease to be used or be useful for any purpose before any allowance may be made for obsolescence."

In the foregoing cases the deduction was allowed under the depreciation statute, now § 167, I.R.C., presumably because the discontinuance of the business was predictable in a future year.

This rule was criticized and not followed, however, by the Ninth Court of Appeals. In *Keller Street Development Co.* v. *Commissioner,* (1963) 323 F. 2d 166, the court could see no logical reason why an obsolescence loss would be allowed if spread over 13 months and be denied where it occurred over a period of less than 12 months.

There is no logical reason why an obsolescence loss on account of discontinuance of a business should be allowed where it is predictable and denied where it happens suddenly and is not predictable.

Regulation 39.23(e)-3 of the 1939 Code specifically states that where through some change in business condition, the usefulness in business of some or all of its assets is suddenly terminated so that the taxpayer discontinues his business he may claim the deduction in the year in which he takes such action. It is submitted that a loss may be claimed under this regulation as it was in full force and effect as a temporary regulation under the 1954 Code (see T.D. 6991, F.R. 5167, August 17, 1954). The Government contends that permanent regulation 1.167(a) 8, adopted in 1960, is retroactive and changes the law applicable to our case.

In the first place, the Commissioner does not have the power to change the law. Administrative regulations are interpretive of the statute which the administrator is empowered to enforce, and are persuasive as to the in-

terpretation given. Where a statute has been enacted and re-enacted, as is the case with § 165 I.R.C., 1954, under substantially the same administrative interpretation, the Commissioner cannot by regulation in 1960 change the prior acquired, substantive rights of parties involved. It has long been held that treasury regulations and interpretations thereof long continued without substantial changes, applying to amended or substantially re-enacted statutes are deemed to have Congressional approval and have the effect of law. *Helvering, Commissioner* v. *Winnell,* 305 U.S. 79, 59 S. Ct. 45; based on the foregoing previous interpretation of § 165(a) under prior regulations must still hold since this section of the I.R.C. has been in effect since 1918 or before.

In the second place, it is submitted that the Commissioner has not changed the interpretation of § 165(a) I.R.C., whether construed by the 1939 regulations or the revised regulations adopted in 1960 for the 1954 I.R.C. The regulations under § 165(a) I.R.C. 1954 (Par. 1.165-2 (c)), refers to regulations 1.167(a)-8 in the case of depreciable property permanently withdrawn from use in the trade or business or production of income. The old regulation, under former § 165(a) referred to discontinuance of the business; Reg. 1.167(a)-8 refers to the retirement of an asset from trade or business, an obvious result of discontinuance of the business. The loss here falls under retirement as set forth in Treasury Regulation par. 1.167 (a)-8 (3) and sub-par. (b), not sub-paragraph (4) relating to abandonment. The definition given in the regulation of the word "retirement" is certainly consistent with discontinuance of business. In fact, permanent discontinuance of business is certain proof that the assets have been retired from use in that business.

It will be noted that Reg. 1.165-2 with reference to obsolescence loss on account of non-depreciable property continues the deduction upon discontinuance of business. For many years, non-depreciable assets and depreciable assets were covered alike under Regulation 39.23(e) 3. There is no reason why the loss on account of non-depreciable property should continue to be allowed on discontinuance of a business, and loss on account of depreciable property should be denied in such event.

While it does not appear that the Commissioner clarified the law by the permanent regulations, if analyzed, it does not seem that he repealed any deductions theretofore allowed.

The court in *Keller Street Development Co.* v. *Commissioner* (supra) commenting on the permanent regulations said:

> "Keeping in mind that § 167 formerly 23 (1) of the 1939 Internal Revenue Code has remained substantially the same, we find treasury regulations apparently shifting in such a way as to obscure their meaning and make them of little help in interpreting the section in question. In 1942, it could be concluded from Bulletin 'F' (revised January 1942) that obsolescence could occur at practically any time."

The court held that the taxpayer could take obsolescence loss on account of machinery purchased for a new brewery when the taxpayer decided not to build a new brewery and continue in business because change in trade practices made their business unprofitable.

In *Mertens on Taxation*, Vol. IV, it is aptly stated that in principle the concept of obsolescence is simple and devoid of any mystery. Not unlike simple tax concepts, however, difficulty frequently arises in application. Ob-

solescence is, like ordinary depreciation, a question of fact in each case. Its existence must be established by proof and when that occurs, its allowability as a deduction is assured. (Also *Rodeo-Vallejo Ferry Co.* v. *Commissioner*, supra, to like effect.)

The fine-spun technical contentions of the Government overlook the basic reason Congress allows the deduction of depreciation and obsolescence whether the latter be classified as "ordinary" or, "extraordinary or special" or "loss of useful value".

The basic reason for depreciation is to give the taxpayer relief and a deduction from ordinary income for the loss of invested capital due to the "wearing out" of an asset. In fixing the time of such relief, depreciation rates are fixed at the time of acquisition of the asset, based upon the period of usefulness of the asset in the taxpayer's business. The basis of the so-called obsolescence deduction is that the taxpayer has suffered a loss of capital investment in the asset from a cause not contemplated in setting the applicable depreciation rates (Reg. § 1.167(b)). Obviously, termination of a business by prohibition laws, the building of a bridge, the ending of a war, change in competition which renders the taxpayer's business unprofitable, and bankruptcy, could not have been contemplated in fixing the depreciation rate. The unexpected financial loss is deductible when it in fact occurs.

In the present case, the pre-trial stipulation admits an economic loss of $456,735.00 on account of the packing house and machinery at the time the taxpayer was forced, against its will, to discontinue its business on June 26, 1959. It is stipulated that this loss existed on that date. Of the adjusted capital investment of $720,735.00, only salvage value remained. The amount of this salvage value

is stipulated to be $263,000.00. The amount of loss and time of loss are established by this stipulation. It should be allowed as a deduction in that year.

CONCLUSION

We respectfully say that this Court should grant the certiorari applied for herein. There is a scarcity of authority as to treatment of a bankruptcy or Chapter XI proceeding as an event or happening of one is required for the deduction under Section 165. The adjudication by the United States District Court for a corporation is a real event. The property and all right, title and interest thereto immediately vests in the trustee in bankruptcy. The officers, directors and stockholders are suddenly ousted of any control of the corporation. The employment of all other staff members or employees who have been operating the business automatically ceases, subject only to their right for back pay. Executory contracts are subject to termination. The right to continue as a going business for the protection of the good will, trade name and customer associations is immediately broken off. To say that nothing occurs when a corporation is adjudicated a bankrupt or that it is not an event that would trigger the operation of Section 165 is not facing the reality of the situation.

In 1959, there were no Internal Revenue Regulations in existence which specifically mentioned this situation. However, in 1961, regulations were adopted under Section 166 of the Code, the regulation referred to being 1.166-2. This regulation was added as of July 31, 1959, just shortly after the bankruptcy adjudication in the case at bar on June 26, 1959 (T.D. 6403, July 31, 1959, 24 F.R. 6160). This regulation and section of the statute are not directly in controversy, but we wish to bring to the Court's atten-

tion that in this regulation which deals with evidence of worthlessness of a creditor's claim and the right for the creditor to charge off all or part of a debt as a bad debt, the event of bankruptcy is recognized under Regulation 1.166-2, ¶ (c), as follows:

> (c) *Bankruptcy*—(1) *General rule.* Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.
>
> (2) *Year of deduction.* In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year."

The sense of this regulation is certainly clear enough to prevent the Government through the Commissioner of Internal Revenue and his agents from contending that bankruptcy has no recognition and no place as a determining factor in the economic life of a corporation. If the mere action of the board of directors to give up the operation of a certain piece of property or the mere building of a bridge may have the effect of putting a ferry-boat company out of business, then why is not the involuntary adjudication of a corporation as a bankrupt such an event that will bring into being the protection and relief afforded by the law under Section 165?

We respectfully say that the petition for certiorari should be granted and the opinion of December 1, 1966 of the United States Court of Appeals for the Fifth Circuit

should be reversed and judgment entered for the petitioners.

Respectfully submitted,

WILLIAM GRESHAM WARD
1240 duPont Building
Miami, Florida 33131
Attorney for Petitioners

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit has been mailed this ..... day of May, 1967, to the Hon. William A. Meadows, Jr., United States Attorney, P. O. Box 1070, Post Office Building, Miami, Florida, and Hon. Louis F. Oberdorfer, Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D. C. 20530.

WILLIAM GRESHAM WARD

APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 22540

B & L FARMS CO., ET AL.,

Appellant,

versus

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Southern District of Florida.

(December 1, 1966.)

Before PHILLIPS,* JONES and BROWN, Circuit Judges.

PER CURIAM: The facts of the suit for a tax refund from which this appeal stems are set forth in the opinion of the district court. *B & L Farms Co.* v. *United States,* 238 F. Supp. 407. The conclusions reached by the district court are correct and its judgment is free from error. That judgment is AFFIRMED.

---

*Senior Judge, Tenth Circuit, sitting by designation.

BROWN, Circuit Judge, dissenting in part:

I concur fully in the Court's affirmance of the District Court's disallowance of the claimed deductions under Sections 165 and 167, 26 USCA §§165, 167. But I disagree as to §162, 26 USCA §162.

The Taxpayer entity is the corporate bankrupt. On the date of adjudication the Bankrupt owed large sums for costs incurred in the growing of produce. These were admittedly "ordinary and necessary expenses" for "carrying on [the] trade or business," 26 USCA §162. On adjudication the Bankrupt lost irrevocably control over the use or disposition of corporate assets. From that moment on such assets were held irrevocably for (a) general creditors and (b) administration expenses—each and both items which may have been of an unknown amount at the time, but each of which was ascertainable in due course.

By virtue of our ruling we now hold that the Taxpayer had not "paid" these debts in the year of adjudication and that they were not "paid" until the year in which creditors received dividends. The effect of this is to give the Government a super priority for taxes—taxes not really due and, conversely, to deprive general creditors of $162,000 of assets for further distribution.

By every realistic standard the creditors were "paid" at the moment the Trustee came into possession and control of the Bankrupt's assets under the inescapable obligation to hold and distribute them (or their proceeds) to creditors. Bankruptcy law and tax law ought to coalesce to produce a realistic result.

Prior to bankruptcy the Bankrupt had kept its books and reported its income on a cash basis, on a fiscal year beginning August 1 and ending July 31. During fiscal

year 1958 (ending July 31, 1958) the company incurred debts in excess of $2,500,000 for fertilizer, insecticides, and other deductible business expenses, but as the result of a freeze made no crop. On August 1, 1958, the first day of fiscal 1959, it filed a petition under Chapter XI of the Bankruptcy Act, and failing an arrangement, was adjudicated on June 26, 1959, within the same fiscal 1959 year. The Trustees in bankruptcy have applied for recovery of $162,538.73 in income taxes paid for the year ending July 31, 1956, under an asserted carry-back under Section 172 of the Internal Revenue Code of 1954. This the Government opposes because, though the property of the Bankrupt did pass to the Trustees within fiscal year 1959, the Trustees did not actually *pay* dividends to the creditors until a later year, beyond the permissible carry-back three-year period. From an adverse ruling of the District Court, the Trustees in bankruptcy have prosecuted this appeal.

The District Court and now this Court misconstrues the character and function of the Trustee in bankruptcy. He is far more than a mere "collection agent" for the creditors. Under Section 70a of the Bankruptcy Act, 11 USCA §110a, the Trustee is vested by operation of law as of the date of bankruptcy with title to all of the non-exempt property of a bankrupt. Since the Bankruptcy Act of 1867 the Congress has recognized that insolvent estates are trusts, of which the creditors are the beneficiaries,[1] and this Court has been on record since 1900 as recognizing that these estates belong to the creditors.[2] That the Trustee's obligation, first, foremost, and always, is to the creditors is the consistent theme running throughout the Act. His duties to the bankrupt (as, setting aside

1. Section 44 of the Bankruptcy Act, 11 USCA §72; 2 Collier on Bankruptcy, para. 44.01.

2. Atkins v. Wilcox, 5 Cir., ..., 105 Fed. 595, 5 Am.B.R. 313.

the bankrupt's exemptions[3]) are merely incidental to the proper administration and liquidation of the estate which passes to him by operation of law for the creditors' benefit. His receipts from liquidation of the estate are taxed with the costs of liquidation and with the costs of court (called administrative costs by the District Court), it is true, but this is because the Congress has determined that the creditors, for whom the estate is administered, and not the public at large, must pay the costs directly involved, and not because the Trustee is any the less the creditors' trustee.

Section 63 of the Bankruptcy Act, 11 USCA §103, which matures all of the debts of the bankrupt on the date of bankruptcy (even those which, under the agreement of the parties, do not fall due until after the bankruptcy petition is filed), is the natural corollary of §70. At the instant of bankruptcy the title to the assets vest in the Trustee, in trust for the creditors, pro rata according to the debts held by them as of that same instant. True, at that instant no creditor is entitled to receive, or to demand, from the Trustee any sum certain. The exact amount each creditor will receive must await the converting of the property to cash and the payment of the costs. But mere postponement of enjoyment has never been held to disqualify an interest as "property."[4]

As the District Court has observed, payment in cash *or its equivalent* has long been recognized. The transfer by operation of law of the assets of the bankrupt to the trustee amounted to exactly that.

I would reverse the case.

---

3. Section 47a(6) of the Act, 11 USCA §75a(6).

4. Sharing in the distribution of the estate is contingent upon the timely filing of a claim. Section 57n of the Act, 11 USCA §93n, requiring the filing of claims within six months of the first date set for the first meeting of creditors is nothing more than a statute of limitations, and cannot be construed as any divestment of ownership of the property as of the date of bankruptcy.

APPENDIX "B"

FOR THE FIFTH CIRCUIT

No. 22540

B & L FARMS CO., ET AL.,

Appellants,

versus

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Southern District of Florida.

On Petition for Rehearing

(February 15, 1967.)

Before PHILLIPS,* JONES and BROWN, Circuit Judges.

PER CURIAM: The appellants have petitioned the Court for a rehearing and rely upon *Nicholas, trustee,* v. *United States,* 384 U.S. 678, 86 S.Ct. 1674, 16 L.Ed. 2d 853, to support their contention that the opinion and decision of the Court are wrong. Our consideration leads to the conclusion that the *Nicholas* case does not require any change of position on the part of the Court. The petition for rehearing is

DENIED.

BROWN, Circuit Judge, Dissents.

---

*Senior Judge, Tenth Circuit, sitting by designation.

APPENDIX "C"

CHARLES R. STUART, PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 89096. Promulgated November 15, 1938.

In 1933 a judgment was obtained against the petitioner and other defendants of more than $7,000,000 upon the ground of his liability as a director of the Guaranty Building & Loan Association of Los Angeles. The amount of the judgment was far in excess of the value of petitioner's property. In 1934 the petitioner went into voluntary bankruptcy and turned over to the trustee appointed by the court all of his property, which had cost him $76,800. He was discharged from bankruptcy in 1934. Petitioner kept his books of account and made his tax returns upon the cash receipts and disbursements basis. *Held*, that the petitioner in 1934 sustained a loss deductible from gross income of at least $12,621.06—the amount of the net income determined by the respondent for 1934.

Raymond R. Hails, Esq., and *A. L. Moreton, C. P. A.*, for the petitioner.

Alra C. Baird, Esq., for the respondent.

Opinion.

SMITH: In this proceeding the petitioner seeks the redetermination of a deficiency in income tax for 1934 of $756.33. The question in issue is whether the petitioner sustained a deductible loss of at least $12,621.06—the amount of the net income determined by the respondent resulting from the petitioner having, during 1934, turned over to the trustee for his bankrupt estate real and personal property which had cost him $76,800.

The facts have all been stipulated. They may be summarized as follows:

The petitioner is a resident of the City of Glendale, County of Los Angeles, California. He filed an income tax return for 1934 which shows as his total gross income $13,750 representing one-half of the salary which he received from Chas. R. Stuart, Inc. He claimed the deduction from gross income of a loss of $41,200. The return showed a net loss of $28,578.94. The deduction of the $41,200 was disallowed by the respondent in the determination of the deficiency, and a net income of $12,621.06 determined.

The petitioner was a director and vice president of the Guaranty Building & Loan Association of Los Angeles from the date of its organization in 1921 to the time of the confessed defalcation of Gilbert H. Bessemyer in December 1930.

The petitioner also became a director of United States Guaranty Corporation at the time of its organization and continued to act as a director of that corporation at all times between the date of its organization and the time Bessemyer confessed his defalcation.

On or about December 15, 1930, there was filed in the Superior Court of the State of California, in and for the County of Los Angeles, an action entitled "W. H. Douglas v. Guaranty Building and Loan Association of Los Angeles, et al., No. 313-332." The petitioner was made a defendant in that action as a director of the Building & Loan Association. Thereafter, and on or about September 28, 1933, pursuant to stipulation, a judgment was entered against the petitioner and other defendants in that action in the amount of $7,661,793. The petitioner was

insolvent at all times between the date of the judgment on September 28, 1933, and January 9, 1934, when a petition in voluntary bankruptcy was filed.

On April 29, 1931, Ernest U. Schroeter, as trustee in bankruptcy for the United States Guaranty Corporation, filed a suit in the Superior Court of the State of California, in and for the County of Los Angeles, No. 320-640, against Gilbert H. Bessemyer, petitioner, and the other directors of the United States Guaranty Corporation, praying for a judgment of $193,333.86. That action was never brought to trial but was dismissed as to petitioner on May 15, 1934.

During 1931 seven suits were instituted in the Municipal Court of the City of Los Angeles in which petitioner was named a defendant. All of the suits were based either upon petitioner's liability as a director or a stockholder in the Guaranty Building & Loan Association of Los Angeles or United States Guaranty Corporation. With the exception of one of the suits, in which judgment was rendered for the defendant for costs, the remaining suits are still pending and unadjudicated.

On January 9, 1934, the petitioner filed in the United States District Court for the Southern District of California a voluntary petition in bankruptcy, and was adjudicated a bankrupt. On February 19, 1934, Hiram E. Casey was appointed trustee in bankruptcy in the bankruptcy proceeding.

By virtue of his appointment as trustee, Hiram E. Casey acquired from the petitioner by operation of law and without other consideration title to all of the property belonging to petitioner. Actual delivery of the property

was made to the trustee by the petitioner during the month of February 1934. The assets turned over to the trustee were as follows:

Item No.	Description of assets	Cost to petitioner
1	Certain real property located on Vine Street in Los Angeles, known as Leland tract, acquired Dec. 24, 1925, and Apr. 17, 1927	$41,200
2	34 shares of the capital stock of Charles R. Stuart, Inc., a California corporation, evidenced by certificate No. 1 (acquired in 1933)	850
3	317 shares of the capital stock of Harry E. Jones, Inc., evidenced by certificates Nos. 117 and 155 (acquired from 3/4/26 to 3/12/30)	31,830
4	7 shares of the capital stock of Transamerica Corporation	420
5	Special life membership in Flintridge Country Club (acquired about 1921)	1,000
6	Northeasterly half of lot 35, and all of lot 36 of tract 7891, County of Los Angeles	1,500

The total claims proven against petitioner's bankrupt estate were as follows:

Claimant	Court and case No.	Amount of claim
A. N. Kemp, trustee in Equity for Guaranty Building & Loan Association of Los Angeles.	Superior 313-332	$7,661,793.00
Andrew J. Jenkins	Municipal 236-028	182.93
Ernest U. Schroeter, as trustee in Bankruptcy for United States Guaranty Corporation.	Superior 320-640	193,333.86
Anthony J. Jacobs	Municipal 238-857	977.92
Saul S. and Ida Klein	Municipal 238-855	1,285.42
Total		7,857,573.13

No dividends have been paid as yet to any of these claimants by the trustee.

In his income tax return for 1934 petitioner claimed no loss for any assets turned over to the trustee in bankruptcy except on the Leland Tract which was acquired by the petitioner on December 24, 1925, and April 17, 1927, at a cost of $41,200.

The petitioner has at all times made his income tax returns, including his return for 1934, on the cash receipts and disbursements basis.

Petitioner received his discharge in bankruptcy on June 4, 1934.

The petitioner sustained a loss in 1934 as the result of acting as a director of the Guaranty Building & Loan Association. The loss sustained, in the amount of at least $12,621.06, is a legal deduction from gross income.

The question presented by this proceeding is whether the petitioner sustained a loss in 1934 which is deductible from gross income; and, if so, the amount thereof. The respondent submits that petitioner was insolvent in 1933 and that he sustained no deductible loss when he turned his property over to the trustee in bankruptcy.

The reason for the disallowance by the respondent of the claimed deduction of $41,200 from the gross income of 1934 is as follows:

> The loss on the sale of the Leland Tract has been disallowed in accordance with I. T. 2898, Cumulative Bulletin XIV—1, page 70, which states that a taxpayer may not deduct as a loss in computing his net income either for the year in which he was adjudicated a bankrupt or for the year in which he received a discharge in bankruptcy under the National Bankruptcy Act, the cost or other basis of the property turned over by him to the trustee in bankruptcy to be applied in payment of his indebtedness in accordance with the provisions of that Act.

The pertinent provisions of the Revenue Act of 1934 are as follows:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * * * *

(e) LOSSES BY INDIVIDUALS.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. * * *

Article 23 (e)-1 of Regulations 86 provides in material part as follows:

Losses by individuals.—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, * * *

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. * * *

In his brief the respondent submits:

* * * the petitioner's contentions [with respect to the claimed deduction of a loss of $41,200] are without merit because the facts clearly show that he made no payment on the judgment as such at any time and if the books of petitioner had been kept on the ac-

crual system then the loss, if any, would have been deductible in 1933 when the judgment was entered against him. While it is true that by the transfer of his assets to the trustee in bankruptcy, the petitioner was forever divested of his said property, nevertheless he at the same time as a result of the whole proceedings, namely, his discharge in bankruptcy, was benefited by the cancellation of adjudicated indebtedness against him, which amounted to a sum that was many times more than the value of the property. * * *

In article 43-2 of Regulations 86, promulgated under the provisions of the Revenue Act of 1934, it is stated:

> * * * Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *

The Board is of the opinion that there can be no question but that the petitioner sustained a loss of 1933 or 1934 greatly in excess of $12,621.06, the amount of the net income determined by the respondent. He clearly lost in either one year or the other all of his property which cost him $76,800.

The respondent makes no contention that the loss was not one sustained "in trade or business." We think that no such contention could validly be made. The judgment was obtained against the petitioner by reason of his having been a director and vice president of the Guaranty Building & Loan Association of Los Angeles. This was

a business undertaking of the petitioner and the loss was one sustained in trade or business.

The respondent admits that if the petitioner had kept his books of account upon the accrual basis rather than upon the cash receipts and disbursements basis the loss sustained by the petitioner would have been a legal deduction from the gross income of 1933, the year in which a final judgment was obtained against him. Since the petitioner kept his books of account and made his tax returns upon the cash receipts and disbursements basis the loss was not "sustained" in 1933 within the meaning of the income tax acts. We do not believe that it was the intention of Congress to deprive taxpayers making their returns on a cash receipts and disbursements basis of losses which would be deductible in returns made on the accrual basis. The only difference in treatment countenanced by the income tax law is the year of deduction. The petitioner made his returns on a cash receipts and disbursements basis. His loss was sustained in 1934, the year in which he lost his property. Cf. *Sidney-Hill System of Health Building Co.*, 12 B. T. A. 548.

The contention of the respondent appears to be that since the petitioner went into bankruptcy in 1934 he is precluded from deducting the loss. His sole reliance is on I.T. 2898, *supra*, which was apparently written to cover this case. We are of the opinion that the bankruptcy proceeding has nothing to do with the deductibility of the loss.

In *Yoder* v. *Nauts*, 34 Fed. (2d) 450, it was held that, where an officer of a corporation guaranteed another against certain losses anticipated as possible in 1920 and this guaranty ripened into liquidated indebtedness in 1921, which was met by delivery of promissory notes, such losses

became "business losses" to the taxpayer as and when the notes were paid.

In *John P. Dillon,* 9 B. T. A. 177, it was held that a payment made by a guarantor for relief from liability, past and future, under a guarantee contract constituted a deductible loss.

The Board has held that where a payment was made in satisfaction of judgments obtained under mechanics' liens the payment was a legal deduction from gross income, *Leichner & Jordan Co.*, 4 B. T. A. 133; that where profits were surrendered in order to avoid a damage suit the amount thereof was likewise a legal deduction, *W. R. Hervey,* 25 B. T. A. 1282; also, that where a payment was made to settle a controversy over stock fraudulently issued the amount paid was a legal deduction, *North American Investment Co.*, 24 B. T. A. 419.

In O. D. 978, Cumulative Bulletin No. 5, p. 135, a taxpayer was allowed a deduction on account of payment of a judgment based upon his misrepresentations in a real estate deal. In O. D. 1091, Cumulative Bulletin No. 5, p. 139, it was held that an amount paid out in compromise of a judgment recovered in a suit against a taxpayer on account of dereliction and neglect of his duty while serving as a director of a bank was an allowable deduction. In I.T. 1853, Cumulative Bulletin II-2, p. 124, it was held that an amount paid in liquidation of a judgment recovered against the taxpayer for the recovery of secret profits arising from the purchase of certain property on behalf of a corporation formed by him and others was deductible from gross income.

In *In re Park's Estate* (C.C.A., 2d Cir.) 58 Fed. (2d) 965, it was held that an amount paid in to a bank by the president to prevent closing thereof because of the treas-

urer's defalcations was not deductible from the president's income. The court observed that the president "did not put in his $100,000 in additional money in settlement of any recognized legal liability so to do." It held that the amount was simply an additional investment in the shares of stock owned by the president. That case is distinguishable from the proceeding at bar, for here the petitioner had a legal liability arising from his being a director of the Guaranty Building & Loan Association of Los Angeles.

The Board is of the opinion that it was not the intention of Congress in the enactment of the Revenue Act of 1934, or of any other revenue act, to disallow the deduction from gross income of losses arising from purely business transactions. We think it clear that if the petitioner in 1934 had sold the assets which he later turned in to the trustee in bankruptcy and paid the cash in compromise of his liability on the judgment, the amount paid would be a legal deduction from gross income. We can not see how the fact that he paid his property in to a trustee in bankruptcy bars him from the deduction of the loss actually sustained.

It will be noted above that the total claims proven against the petitioner's bankrupt estate included three claims as follows:

Claimant	Court case No.	Amount of claim
Andrew J. Jenkins	Municipal 236-028	$ 182.93
Anthony J. Jacobs	Municipal 238-857	977.92
Saul S. and Ida Klein	Municipal 238-855	1,285.42
Total		2,446.27

The stipulated facts do not show the nature of these proven claims. For aught shown to the contrary they may have been claims against the petitioner's bankrupt estate which were not incurred "in trade or business."

It certainly can not be said that a taxpayer sustains a deductible loss in respect of claims proven against his bankrupt estate which were not incurred "in trade or business." The total of such claims was, however, in the instant proceeding, insignificant. The balance of the claims proven against the bankrupt's estate arose from transactions connected with the petitioner's trade or business. To the extent that the petitioner paid off such claims in the taxable year the amount is a legal deduction from gross income.

There may also be a question as to whether the petitioner would be in any event entitled to deduct from his gross income for 1934 the full amount of $76,800 representing the entire cost of all of the property turned in by him to the trustee in bankruptcy in that year. It is questionable whether his purchase of a special life membership in the Flintridge Country Club at a cost of $1,000 is an item of property which was purchased with the expectation of realizing a profit therefrom. It would appear that the investment was for the personal benefit of the petitioner. It may also be true that certain other items of property turned over to the trustee were not purchased with any intention of realizing a profit from them. But we are satisfied that the petitioner's investment of $31,830 in 317 shares of the capital stock of Harry E. Jones, Inc., and the investment of other amounts of money in personal property were made by the petitioner for the purpose of realizing a profit therefrom, and that the cost to the petitioner of such items of property was much in excess of $12,621.06, the amount of the net income determined by the respondent in the determination of the deficiency. The petitioner is entitled to the deduction of a loss of $12,621.06. With the allowance of such deduction the petitioner had no net income for 1934.

Reviewed by the Board.

Judgment of no deficiency will be entered.

APPENDIX "D"

§ 103. Debts which may be proved

(a) Debts of the bankrupt may be proved and allowed against his estate which are founded upon (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition by or against him, whether then payable or not, with any interest thereon which would have been recoverable at that date or with a rebate of interest upon such as were not then payable and did not bear interest; (2) costs taxable against a bankrupt who was at the time of the filing of the petition by or against him plaintiff in a cause of action which would pass to the trustee and which the trustee declines to prosecute after notice; (3) a claim for taxable costs incurred in good faith by a creditor before the filing of the petition in an action to recover a probable[1] debt; (4) an open account, or a contract express or implied; (5) provable debts reduced to judgments after the filing of the petition and before the consideration of the bankrupt's application for a discharge, less costs incurred and interest accrued after the filing of the petition and up to the time of the entry of such judgments; (6) an award of an industrial-accident commission, body, or officer of any State having jurisdiction to make awards of workmen's compensation in case of injury or death from injury, if such injury occurred prior to adjudication; (7) the right to recover damages in any action for negligence instituted prior to and pending at the time of the filing of the petition in bankruptcy; (8) contingent debts and contingent contractual liabilities; or (9) claims

1. So in original. Probably should read "provable".

for anticipatory breach of contracts, executory in whole or in part, including unexpired leases of real or personal property: *Provided, however,* That the claim of a landlord for damages for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued, without acceleration, up to such date: *And provided further,* That in the case of an assignment of any such claim for damages, the court shall, in determining the amount thereof, examine the circumstances of the assignment and the consideration paid or to be paid therefor, and may allow the claim of the assignee in such amount, subject to the provisions of the foregoing proviso of this clause, as will be fair and equitable.

(b) In the interval after the filing of an involuntary petition and before the appointment of a receiver or the adjudication, whichever first occurs, a claim arising in favor of a creditor by reason of property transferred or services rendered by the creditor to the bankrupt for the benefit of the estate shall be provable to the extent of the value of such property or services.

(c) Notwithstanding any State law to the contrary, the rejection of an executory contract or unexpired lease, as provided in this title, shall constitute a breach of such contract or lease as of the date of the filing of the petition initiating a proceeding under this title.

(d) Where any contingent or unliquidated claim has been proved, but, as provided in subdivision (d) of section 93 of this title, has not been allowed, such claim shall not be deemed proved under this title. July 1, 1898, c. 541, § 63, 30 Stat. 562; June 7, 1934, c. 424, § 4 (a), 48 Stat. 923; June 18, 1934, c. 580, 48 Stat. 991; June 5, 1936, c. 512, § 1, 49 Stat. 1475; June 22, 1938, c. 575, § 1, 52 Stat. 873; July 7, 1952, c. 579, § 18, 66 Stat. 426.

§ 110. Title to property

(a) The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all of the followng kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor: *Provided*, That in case the trustee, within thirty days after appointment and qualification, does not notify the applicant for a patent, copyright, or trade-mark of his election to prosecute the application to allowance or rejection, the bankrupt may apply to the court for an order revesting him with the title thereto, which petition shall be granted unless for cause shown by the trustee the court grants further time to the trustee for making such election; and such applicant may, in any event, at any time petition the court to be revested with such title in case the trustee shall fail to prosecute such application with reasonable diligence; and the court, upon revesting the bankrupt with such title, shall direct the trustee to execute proper instruments of transfer to make the same effective in law and upon the

records; (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered: *Provided*, That rights of action ex delicto for libel, slander, injuries to the person of the bankrupt or of a relative, whether or not resulting in death, seduction, and criminal conversation shall not vest in the trustee unless by the law of the State such rights of action are subject to attachment, execution, garnishment, sequestration, or other judicial process: *And provided further*, That when any bankrupt, who is a natural person, shall have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the policy shall pass to the trustee as assets; (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of

creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this title, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court.

All property, wherever located, except insofar as it is property which is held to be exempt, which vests in the bankrupt within six months after bankruptcy by bequest, devise or inheritance shall vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date when it vested in the bankrupt, and shall be free and discharged from any transfer made or suffered by the bankrupt after bankruptcy.

All property, wherever located, except insofar as it is property which is held to be exempt, in which the bankrupt has at the date of bankruptcy an estate or interest by the entirety and which within six months after bankruptcy becomes transferable in whole or in part solely by the bankrupt shall, to the extent it becomes so transferable, vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date of bankruptcy.

The title of the trustee shall not be affected by the prior possession of a receiver or other officer of any court.

(b) Within sixty days after the adjudication, the trustee shall assume or reject any executory contract, including unexpired leases of real property: *Provided, however,* That the court may for cause shown extend or reduce such period of time. Any such contract or lease not assumed or rejected within such time, whether or not a trustee has been appointed or has qualified, shall be deemed to be rejected. A trustee shall file, within sixty days after adjudication, a statement under oath showing

which, if any, of the contracts of the bankrupt are executory in whole or in part, including unexpired leases of real property, and which, if any, have been rejected by the trustee: *Provided, however,* That the court may for cause shown extend or reduce such period of time. Unless a lease of real property shall expressly otherwise provide, a rejection of such lease or of any covenant therein by the trustee of the lessor shall not deprive the lessee of his estate. A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same shall be enforceable. A trustee who elects to assume a contract or lease of the bankrupt and who subsequently, with the approval of the court and upon such terms and conditions as the court may fix after hearing upon notice to the other party to the contract or lease, assigns such contract or lease to a third person, shall not be liable for breaches occurring after such assignment.

(c) The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.

(d) After bankruptcy and either before adjudication or before a receiver takes possession of the property of the bankrupt, whichever first occurs—

(1) A transfer of any of the property of the bankrupt, other than real estate, made to a person acting in good faith shall be valid against the trustee if made for a present fair equivalent value or, if not made for a present fair equivalent value, then to the extent of the present consideration actually paid therefor, for which amount the transferee shall have a lien upon the property so transferred;

(2) A person indebted to the bankrupt or holding property of the bankrupt may, if acting in good faith, pay such indebtedness or deliver such property, or any part thereof, to the bankrupt or upon his order, with the same effect as if the bankruptcy were not pending;

(3) A person having actual knowledge of such pending bankruptcy shall be deemed not to act in good faith unless he has reasonable cause to believe that the petition in bankruptcy is not well founded;

(4) The provisions of paragraphs (1) and (2) of this subdivision shall not apply where a receiver or trustee appointed by a United States or State court is in possession of all or the greater portion of the non-exempt property of the bankrupt;

(5) A person asserting the validity of a transfer under this subdivision shall have the burden of proof. Except as otherwise provided in this subdivision and in subdivision g of section 44 of this title, no transfer by or in behalf of the bankrupt after the date of bankruptcy shall be valid against the trustee: *Provided, however,* That nothing in this title shall impair the negotiability of currency or negotiable instruments.

(e) (1) A transfer made or suffered or obligation incurred by a debtor or adjudged a bankrupt under this title which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title, shall be null and void as against the trustee of such debtor.

(2) All property of the debtor affected by any such transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every such transfer or obligation shall be avoided by, the trustee for the benefit of the estate: *Provided, however,* That the court may on due notice order such transfer or obligation to be preserved for the benefit of the estate and in such event the trustee shall succeed to and may enforce the rights of such transferee or obligee. The trustee shall reclaim and recover such property or collect its value from and avoid such transfer or obligation against whoever may hold or have received it, except a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision is valid under applicable Federal or state laws.

(3) For the purpose of such recovery or of the avoidance of such transfer or obligation, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

(f) The court shall appoint a competent and disinterested appraiser and upon cause shown may appoint additional appraisers, who shall appraise all the items of real and personal property belonging to the bankrupt estate and who shall prepare and file with the court their report thereof. Real and personal property shall, when practicable, be sold subject to the approval of the court. It shall

not be sold otherwise than subject to the approval of the court for less than 75 per centum of its appraised value. Whenever any sale of real or personal property of any bankrupt is made by or through any auctioneer employed by the court, receiver, or trustee, such auctioneer, if an individual or a partnership, shall be a bonafide resident and citizen of the judicial district in which the property to be sold is situated, or, if a corporation, shall be lawfully domesticated and authorized to transact such business in the State in which said judicial district is located.

(g) The title to property of a bankrupt estate which has been sold, as herein provided, shall be conveyed to the purchaser by the trustee.

(h) Repealed. July 7, 1952, c. 579, § 23(g), 66 Stat. 430.

(i) Upon the confirmation of an arrangement or plan, or at such later time as may be provided by the arrangement or plan, or in the order confirming the arrangement or plan, the title to the property dealt with shall revest in the bankrupt or debtor, or vest in such other person as may be provided by the arrangement or plan or in the order confirming the arrangement or plan. July 1, 1898, c. 541, § 70, 30 Stat. 565; Feb. 5, 1903, c. 487, § 16, 32 Stat. 800; May 27, 1926, c. 406, § 16, 44 Stat. 667; June 22, 1938, c. 575, § 1, 52 Stat. 879; Mar. 18, 1950, c. 70, § 2, 64 Stat. 23; July 7, 1952, c. 579, § 23, 66 Stat. 429.

* * * * * * * *

(b) The trustee shall assume or reject an executory contract, including an unexpired lease of real property, within sixty days after the adjudication or within thirty days after the qualification of the trustee, whichever is later, but the court may for cause shown extend or reduce the time. Any such contract or lease not assumed or rejected within that time shall be deemed to be rejected.

If a trustee is not appointed, any such contract or lease shall be deemed to be rejected within thirty days after the date of the order directing that a trustee be not appointed. A trustee shall file, within sixty days after adjudication or within thirty days after he has qualified, whichever is later, unless the court for cause shown extends or reduces the time, a statement under oath showing which, if any, of the contracts of the bankrupt are executory in whole or in part, including unexpired leases of real property, and which, if any, have been rejected by the trustee. Unless a lease of real property expressly otherwise provides, a rejection of the lease or of any covenant therein by the trustee of the lessor does not deprive the lessee of his estate. A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same is enforcible. A trustee who elects to assume a contract or lease of the bankrupt and who subsequently, with the approval of the court and upon such terms and conditions as the court may fix after hearing upon notice to the other party to the contract or lease, assigns the contract or lease to a third person, is not liable for breaches occurring after the assignment.

(c) The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee shall have as of the date of bankruptcy

the rights and powers of: (1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists. If a transfer is valid in part against creditors whose rights and powers are conferred upon the trustee under this subdivision, it shall be valid to a like extent against the trustee. In cases where repugnancy or inconsistency exists with reference to the rights and powers in this subdivision conferred, the trustee may elect which rights and powers to exercise with reference to a particular party, a particular remedy, or a particular transaction, without prejudice to his right to maintain a different position with reference to a different party, a different remedy, or a different transaction.

* * * * * * *

(f) The court shall appoint a competent and disinterested appraiser and upon cause shown may appoint additional appraisers, who shall appraise all the items of real and personal property belonging to the bankrupt estate and who shall prepare and file with the court their report thereof. Real and personal property shall, when practicable, be sold subject to the approval of the court. It shall not be sold otherwise than subject to the approval of the court for less than 75 per centum of its appraised value. Whenever a sale of real or personal property of a bankrupt is made by or through an auctioneer employed

by the court, receiver, or trustee, the auctioneer must be a duly licensed or authorized auctioneer in the place where the sale is to be conducted. As amended Sept. 25, 1962, Pub. L. 87—681, §§ 9, 10, 76 Stat. 571; July 5, 1966, Pub. L. 89—495, § 5, 80 Stat. 269.

* * * * * * * *

SUBCHAPTER I—CONSTRUCTION

§ 701. Exclusive application of chapter

The provisions of this chapter shall apply exclusively to proceedings under this chapter. July 1, 1898, c. 541, § 301, as added June 22, 1938, c. 575, § 1, 52 Stat. 905.

§ 702. Application of other provisions

The provisions of chapters 1 to 7, inclusive, of this title shall, insofar as they are not inconsistent with or in conflict with the provisions of this chapter, apply in proceedings under this chapter. For the purposes of such application, provisions relating to "bankrupts" shall be deemed to relate also to "debtors", and "bankruptcy proceedings" or "proceedings in bankruptcy" shall be deemed to include proceedings under this chapter. For the purposes of such application the date of the filing of the petition in bankruptcy shall be taken to be the date of the filing of an original petition under section 722 of this title, and the date of adjudication shall be taken to be the date of the filing of the petition under sections 721 or 722 of this title except where an adjudication had previously been entered. July 1, 1898, c. 541, § 302, as added June 22, 1938, c. 575, § 1, 52 Stat. 905.

§ 707. Creditors; debts; claims

Unless inconsistent with the context and for the purposes of an arrangement providing for an extension of time for payment of debts in full and applicable exclusively to the debts to be extended—

(1) "creditors" shall include the holders of all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 103 of this title and whether liquidated or unliquidated, fixed or contingent; and

(2) "debts" or "claims" shall include all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 103 of this title and whether liquidated or unliquidated, fixed or contingent. July 1, 1898, c. 541, § 307, as added June 22, 1938, c. 575, § 1, 52 Stat. 906.

§ 162. Trade or business expenses

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but

amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

(b) Charitable contributions and gifts excepted.—No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section.

(c) Improper payments to officials or employees of foreign countries.—No deduction shall be allowed under subsection (a) for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee.

(d) Capital contributions to Federal National Mortgage Association.—For purposes of this subtitle, whenever the amount of capital contributions evidenced by a share of stock issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., sec. 1718) exceeds the fair market value of the stock as of the issue date of such stock, the initial holder of the stock shall treat the excess as ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

(e) Appearances, etc., with respect to legislation.—

(1) In general.—The deduction allowed by subsection (a) shall include all the ordinary and necessary expenses (including, but not limited to, traveling expenses described in subsection (a) (2) and the cost of preparing testimony) paid or incurred during

the taxable year in carrying on any trade or business—

(A) in direct connection with appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or

(B) in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization,

and that portion of the dues so paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in subparagraphs (A) and (B) carried on by such organization.

(2) **Limitation.**—The provisions of paragraph (1) shall not be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise)—

(A) for participation in, or intervention in, any political campaign on behalf of any candidate for public office, or

(B) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums.

(f) Cross reference.—

For special rule relating to expenses in connection with subdividing real property for sale, see section 1237.

Aug. 16, 1954, c. 736, 68A Stat. 45; Sept. 2, 1958, Pub. L. 85—866, Title I, § 5(a), 72 Stat. 1608; Sept. 14, 1960, Pub. L. 86—779, §§ 7(b), 8(a), 74 Stat. 1002, 1003; Oct. 16, 1962, Pub. L. 87—834, §§ 3(a), 4(b), 76 Stat. 973, 976.

§ 165. Losses

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one

individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

(d) Wagering losses.—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) Theft losses.—For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) Capital losses.—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) Worthless securities.—

(1) General rule.—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security defined.—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) Securities in affiliated corporation.—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corpo-

ration shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

(h) Disaster losses.—Notwithstanding the provisions of subsection (a), any loss

(1) attributable to a disaster which occurs during the period following the close of the taxable year and on or before the time prescribed by law for filing the income tax return for the taxable year (determined without regard to any extension of time), and

(2) occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under sections 1855-1855g of title 42,

at the election of the taxpayer, may be deducted for the taxable year immediately preceding the taxable year in which the disaster occurred. Such deduction shall not be in excess of so much of the loss as would have been deductible in the taxable year in which the casualty occurred. If an election is made under this subsection, the

casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed.

(i) Certain property confiscated by the Government of Cuba.—

(1) Treatment as subsection (c) (3) loss.—For purposes of this chapter, in the case of an individual who was a citizen of the United States, or a resident alien, on December 31, 1958, any loss of property which—

(A) was sustained by reason of the expropriation, intervention, seizure, or similar taking of the property, before January 1, 1964, by the government of Cuba, any political subdivision thereof, or any agency or instrumentality of the foregoing, and

(B) was not a loss described in paragraph (1) or (2) of subsection (c),

shall be treated as a loss to which paragraph (3) of subsection (c) applies. In the case of tangible property, the preceding sentence shall not apply unless the property was held by the taxpayer, and was located in Cuba, on December 31, 1958.

(2) Special rules.—

(A) For purposes of subsection (a), any loss described in paragraph (1) shall be treated as having been sustained on October 14, 1960, unless it is established that the loss was sustained on some other day.

(B) For purposes of subsection (a), the fair market value of property held by the taxpayer on December 31, 1958, to which paragraph (1) applies, on the day on which the loss of such property was sustained, shall be its fair market value on December 31, 1958.

(C) For purposes of section 172, a loss described in paragraph (1) shall not be treated as an expropriation loss within the meaning of section 172(k).

(D) For purposes of section 6601, the amount of any tax imposed by this title shall not be reduced by virtue of this subsection for any period prior to February 26, 1964.

(3) Refunds or credits.—Notwithstanding any law or rule of law, refund or credit of any overpayment attributable to the application of paragraph (1) may be made or allowed if claim therefor is filed before January 1, 1965. No interest shall be allowed with respect to any such refund or credit for any period prior to February 26, 1964.

(j) Cross references.—

(1) For special rule for banks with respect to worthless securities, see section 582.

(2) For disallowance of deduction for worthlessness of securities to which subsection (g) (2) (C) applies, if issued by a political party or similar organization, see section 271.

(3) For special rule for losses on stock in a small business investment company, see section 1242.

(4) For special rule for losses of a small business investment company, see section 1243.

(5) For special rule for losses on small business stock, see section 1244.

Aug. 16, 1954, c. 736, 68A Stat. 49; Sept. 2, 1958, Pub.L. 85-866, Title I, §§ 7, 57(c) (1), Title II, § 202(a), 72 Stat. 1608, 1646, 1676; Mar. 31, 1962, Pub.L. 87-426, § 2(a), 76 Stat. 51; Feb. 26, 1964, Pub.L. 88-272, Title II, §§ 208(a), 238, 78 Stat. 43, 128; June 30, 1964, Pub.L. 88-348, § 3(a), 78 Stat. 237.

§ 172. Net operating loss deduction

(a) Deduction allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net operating loss carrybacks and carryovers.—

(1) Years to which loss may be carried.—

(A) (i) Except as provided in clause (ii) and in subparagraph (D), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraphs (C) and (D), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(C) In the case of a taxpayer which is a regulated transportation corporation (as defined in subsection (j) (1)), a net operating loss for any taxable year ending after December 31, 1955, shall (except as provided in subsection (j)) be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss.

(D) In the case of a taxpayer which has a foreign expropriation loss (as defined in subsection (k)) for any taxable year ending after December 31, 1958, the portion of the net operating loss for such year attributable to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss.

(2) Amount of carrybacks and carryovers.—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1) (D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1) (D) applies, such portion shall be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss.

(3) Special rules.—

(A) Paragraph (1) (A) (ii) shall apply only if—

(i) there has been filed, at such time and in such manner as may be prescribed by the Secretary or his delegate, a notice of filing of the application under section 317 of the Trade Expansion Act of 1962 for tax assistance, and, after its issuance, a copy of the certification under such section, and

(ii) the taxpayer consents in writing to the assessment, within such period as may be agreed upon with the Secretary or his delegate, of any deficiency for any year to the extent attributable to the disallowance of a deduction previously allowed with respect to such net operating loss, even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(B) In the case of—

(i) a partnership and its partners, or

(ii) an electing small business corporation under subchapter S and its shareholders,

paragraph (1) (A) (ii) shall apply as determined under regulations prescribed by the Secretary or his delegate. Such paragraph shall apply to a net operating loss of a partner or such a shareholder only

if it arose predominantly from losses in respect of which certifications under section 317 of the Trade Expansion Act of 1962 were filed under this section.

(C) Paragraph (1) (D) shall apply only if—

(i) the foreign expropriation loss (as defined in subsection (k)) for the taxable year equals or exceeds 50 percent of the net operating loss for the taxable year.

(ii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1963, the taxpayer elects (at such time and in such manner as the Secretary or his delegate by regulations prescribes) to have paragraph (1) (D) apply, and

(iii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1958, and before January 1, 1964, the taxpayer elects (in such manner as the Secretary or his delegate by regulations prescribes) on or before December 31, 1965, to have paragraph (1) (D) apply.

(D) If a taxpayer makes an election under subparagraph (C) (iii), then (notwithstanding any law or rule of law), with respect to any taxable year ending before January 1, 1964, affected by the election—

(i) the time for making or changing any choice or election under subpart A of part III of subchapter N (relating to foreign tax credit) shall not expire before January 1, 1966,

(ii) any deficiency attributable to the election under subparagraph (C) (iii) or to the application of clause (i) of this subparagraph may be assessed at any time before January 1, 1969, and

(iii) refund or credit of any overpayment attributable to the election under subparagraph (C) (iii) or to the application of clause (i) of this subparagraph may be made or allowed if claim therefor is filed before January 1, 1969.

(c) Net operating loss defined.—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications.—The modifications referred to in this section are as follows:

(1) Net operating loss deduction.—No net operating loss deduction shall be allowed.

(2) Capital gains and losses of taxpayers other than corporations.—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deduction for personal exemptions.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness deductions of taxpayers other than corporations.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business,

shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2) (B), and (3) shall be taken into account;

(C) any deduction allowable under section 165(c) (3) (relating to casualty losses) shall not be taken into account; and

(D) any deduction allowed under section 404 or section 405(c) to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c) (1) shall not be treated as attributable to the trade or business of such individual.

(5) Special deductions for corporations.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computation of deduction for dividends received, etc.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a) (1) (B) of such section.

(e) Law applicable to computations.—In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

(f) Taxable years beginning in 1953 and ending in 1954.—In the case of a taxable year beginning in 1953 and ending in 1954—

(1) In lieu of the amount specified in subsection (c), the net operating loss for such year shall be the sum of—

(A) that portion of the net operating loss for such year computed without regard to this subsection which the number of days in the loss year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if this section had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year.

(2) The amount of any net operating loss for such year which shall be carried to the second preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the second taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the second preceding taxable year.

(3) The net operating loss deduction for such year shall be, in lieu of the amount specified in section 122(c) of the Internal Revenue Code of 1939, the sum of—

(A) that portion of the net operating loss deduction for such year, computed as if subsection (a) of this section were applicable to the taxable year, which the number of days in such year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss deduction for such year, computed under section 122 (c) of the Internal Revenue Code of 1939 as if this paragraph had not been enacted, which the number of days in such year before January 1, 1954, bears to the total number of days in such year.

(4) For purposes of the second sentence of subsection (b) (2), the taxable income for such year shall be the sum of—

(A) that portion of the net income for such year, computed without regard to this paragraph, which the number of days in such year before January 1, 1954, bears to the total number of days in such year, and

(B) that portion of the net income for such year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code,

which the number of days in such year after December 31, 1953, bears to the total number of days in such year.

(g) Special transitional rules.—

(1) Losses for taxable years ending before January 1, 1954.—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

(2) Losses for taxable years ending after December 31, 1953.—For purposes of section 122 of the Internal Revenue Code of 1939—

(A) the determination of the taxable years ending before January 1, 1954, to which a net operating loss for any taxable year ending after December 31, 1953, may be carried shall be made under subsection (b) (1) (A) of this section; and

(B) in determining the amount of the carryback to the first taxable year preceding the first taxable year ending after December 31, 1953, the portion of the net operating loss carried to such year shall be such net operating loss reduced by—

(i) the net income for the second preceding taxable year computed as if the second sentence of section 122 (b) (2) (B) of the Internal Revenue Code of 1939 applied, or

(ii) if smaller, the portion of the net operating loss which by reason of subsection (f) of this section is carried to the second preceding taxable year.

(3) Taxable years beginning after December 31, 1953, and ending before August 17, 1954.—In the case of a taxable year which begins after December 31, 1953, and ends before August 17, 1954—

(A) the net operating loss deduction for such year shall be computed as if subsection (a) of this section applied to such taxable year, and

(B) for purposes of the second sentence of subsection (b) (2), the taxable income for such taxable year shall be the net income for such taxable year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code.

(4) Excess profits tax not affected.—For purposes of subchapter D of chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if this section had not been enacted and as if section 122 of such Code continued to apply to taxable years to which this subtitle applies.

(h) Disallowance of net operating loss of electing small business corporations.—In determining the amount of the net operating loss deduction under subsection (a) of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S.

(i) Carryback of net operating loss for taxable years beginning in 1957 and ending in 1958.—In the case of a taxable year beginning 1957 and ending in 1958, the amount of any net operating loss for such year which shall be carried to the third preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1957, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the third taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the third preceding taxable year.

(j) Carryover of net operating loss for certain regulated transportation corporations.—

(1) Definition.—For purposes of subsection (b) (1) (C), the term "regulated transportation corporation" means a corporation—

(A) 80 percent or more of the gross income of which (computed without regard to dividends and capital gains and losses) for the taxable year is derived from the furnishing or sale of transportation described in subparagraph (A), (C) (i), (E), or (F) of section 7701(a) (33) and taken into account for purposes of the limitation contained in the last two sentences of section 7701(a) (33),

(B) which is described in subparagraph (G) or (H) of section 7701(a) (33), or

(C) which is a member of a regulated transportation system.

(2) Regulated Transportation System.—For purposes of this subsection, a corporation shall be treated as a member of a regulated transportation system for a taxable year if—

(A) it is a member of an affiliated group of corporations making a consolidated return for such taxable year, and

(B) 80 percent or more of the aggregate gross income of the members of such affiliated group (computed without regard to dividends and capital gains and losses) for such taxable year is derived from sources described in paragraph (1) (A).

For purposes of subparagraph (B), income derived by a corporation described in subparagraph (G) or (H) of section 7701(a) (33) from leases described in subparagraph (G) thereof shall be considered as derived from sources described in paragraph (1) (A).

(3) Limitation.—For purposes of subsection (b)(1)(C)—

(A) a net operating loss may not be a net operating loss carryover to the 6th taxable year following the loss year unless the taxpayer is a regulated transportation corporation for such 6th taxable year; and

(B) a net operating loss may not be a net operating loss carryover to the 7th taxable year following the loss year unless the taxpayer is a regulated transportation corporation for the 6th taxable year following the loss year and for such 7th taxable year.

(4) Taxable years beginning in 1955 and ending in 1956.—In the case of a net operating loss for a taxable year beginning in 1955 and ending in 1956, the amount of such loss which may be carried—

(A) to the 6th taxable year following the loss year shall be the amount which bears the same ratio to the amount which (but for this paragraph) would be carried to such 6th taxable year as the number of days in the loss year after December 31, 1955, bears to the total number of days in the loss year, and

(B) to the 7th taxable year following the loss year shall be the amount (if any) by which (i) the amount carried to the 6th taxable year (determined under subparagraph (A)), exceeds (ii) the taxable income (computed as provided in subsection (b)(2)) for such 6th taxable year.

(k) Foreign expropriation loss defined.—For purposes of subsection (b)—

(1) The term "foreign expropriation loss" means, for any taxable year, the sum of the losses sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision

thereof, or any agency or instrumentality of the foregoing. For purposes of the preceding sentence, a debt which becomes worthless shall, to the extent of any deduction allowed under section 166(a), be treated as a loss.

(2) The portion of the net operating loss for any taxable year attributable to a foreign expropriation loss is the amount of the foreign expropriation loss for such year (but not in excess of the net operating loss for such year).

(l) Cross references.—

(1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

Aug. 16, 1954, c. 736, 68A Stat. 63; Sept. 2, 1958, Pub.L. 85-866, Title I, §§ 14(a), (b), 64(b), Title II, § 203(a), (b), 72 Stat. 1611, 1656, 1678; Sept. 27, 1962, Pub.L. 87-710, § 1, 76 Stat. 648; Oct. 10, 1962, Pub.L. 87-792, § 7(f), 76 Stat. 829; Oct. 11, 1962, Pub.L. 87-794, Title III, § 317(b), 76 Stat. 889; Feb. 26, 1964, Pub.L. 88-272, Title II, §§ 210(a), (b) (5), 78 Stat. 47, 48, 115.

* * * * * * *

(26 U.S.C. 1958 ed., Sec. 7805.)

Treasury Regulation 118 (1939 Code):

Par. 39.23(e)-3 **Loss of useful value.** (a) When, through some change in business conditions, the usefulness in the business of some or all of the assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the

difference between the basis (adjusted as provided in section 113(b) and par. 39.113(a) (14)-1 and 39.113(b) (1)-1 to 39.113(b) (4)-1, inclusive) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

* * * * * * *

Treasury Regulations on Income Tax (1954 Code):

Par. 1.165-1 **Losses.**

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 159

B & L FARMS CO., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner[1] successfully operated a business of growing and packing produce through July 31, 1956, the end of its 1956 tax year. Thereafter petitioner incurred losses. On August 1, 1958, the first day of its 1959 tax year, petitioner sought and was granted an arrangement under Chapter XI of the Bankruptcy Act. In June 1959 petitioner was adjudicated a bankrupt.

Petitioner argues: 1) the arrangement or bankruptcy proceedings entitled petitioner—a cash basis

[1] "Petitioner" refers to B & L Farms Company. The other petitioners are trustees in bankruptcy of B & L Farms, who will receive any refund to which B & L Farms may be entitled. *Segal* v. *Rochelle*, 382 U.S. 375.

taxpayer—to claim on its 1959 tax return a deduction in the full amount of its outstanding trade indebtedness at the beginning of its 1959 tax year, including amounts not paid until after that year; 2) if petitioner remained a cash basis taxpayer then the transfer of its assets to the trustees in bankruptcy either constituted payment of petitioner's trade debts or constituted a deductible loss; and 3) the permanent suspension of its business operations entitled petitioner to an obsolescense deduction on its building and machinery.

Petitioner's trustees in bankruptcy claimed the deductions, and sought to carry back the resulting loss as a set off against petitioner's 1956 profits. The Commissioner allowed petitioner to deduct only those trade debts that were in fact paid during the 1959 tax year, and a matching carryback against the 1956 profits.[2] The other deductions were disallowed.

Petitioner then sued in the district court for a refund of the remaining $162,538.73 of its 1956 income tax.[3] The district court sustained the Commissioner's action; the Court of Appeals for the Fifth Circuit affirmed, Judge Brown dissenting.

The result below is in accord with the settled state of the law, and there is no occasion for further review.

---

[2] Although further deductions would have been allowed and were claimed in later years when the trade debts were paid and the building and machinery sold, losses in those later years could not be set off against the 1956 losses because of the three-year statutory limitations period.

[3] Allowance of any of one of petitioner's claims would have resulted in a sufficient increase in petitioner's 1959 loss to consume the balance of the 1956 profits (R. 43).

1. Petitioner's claimed deduction of the amount of its unpaid trade debts on its 1959 return now rests principally on the theory that either the Chapter XI arrangement or the adjudication in bankruptcy transformed petitioner from a cash basis to an accrual basis taxpayer.[4] Nothing in the Bankruptcy Act allows such a result—which would be contrary to the accounting requirements of the Internal Revenue Code.

From its incipiency in 1949 until the institution of arrangement and then bankruptcy proceedings during its 1959 tax year, petitioner kept its books on a cash basis. Petitioner, as Section 446(a) of the Internal Revenue Code of 1954 requires, computed its taxable income on the same cash basis. Thus, petitioner could deduct a business debt such as those here in issue only in its return for the tax year during which the liability was liquidated in cash or its equivalent. *E.g., Helvering* v. *Price,* 309 U.S. 409, 413; *P. G. Lake, Inc.* v. *Commissioner,* 148 F. 2d 898, 900 (C.A. 5), certiorari denied, 326 U.S. 732; see Internal Revenue Code of 1954, Section 461(a).

Congress has provided a procedure for changing tax accounting methods, which the Commissioner has implemented through regulations. Section 446(e) of the Code is the only statutory provision that allows an overall change in the accounting method used to compute taxable income. That section requires "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books" to "secure the consent of the Secretary or his delegate" "before computing his tax-

[4] Petitioner first advanced this theory in the court of appeals.

able income under the new method * * *." Section 481(a)(2) requires that any change in tax accounting method take into account such adjustments as are necessary to avoid duplication or omission of items of expense or income. Section 1.446-1(e)(3) of the Treasury Regulations on Income Tax (1954 Code) requires that any application for consent to a change in method be filed within the first 90 days of the tax year for which the change is desired. That regulation also requires as a prerequisite of consent to a change of method that the Commissioner and the taxpayer agree to the adjustments required by Section 481 and other Code provisions.

Neither petitioner nor its trustees in bankruptcy made any attempt to comply with this statutory scheme. Petitioner rather relies on a claim that "after the Chapter XI proceeding was filed * * * the accounts payable for these trade creditors * * * simultaneously become accrued" (Pet. 27)—in substance a claim that the nature of arrangement and bankruptcy proceedings required that petitioner keep its books on an accrual basis.

But even if a change in bookkeeping methods resulted for bankruptcy purposes,[5] a change in tax accounting methods did not automatically follow. The change could not apply to petitioner's tax accounting unless there was adherence to Section 446(e) and 481(a) of the 1954 Code, and the resulting regulations.

[5] It is doubtful in any event that bankruptcy proceedings caused petitioner to use the "accrual method" that Section 446(c)(2) of the 1954 Code allows for tax accounting purposes. The most that can be said is that a trustee in bankruptcy must schedule accounts receivable and payable for all inter-

Nothing in the Bankruptcy Act determines the question of the bankrupt's tax accounting method. But Congress, in the Internal Revenue Code, has defined the duties trustees have in fulfilling the obligations of bankrupt corporations under the tax laws. Section 6012(b)(3)—which petitioner ignores—requires that a trustee in bankruptcy of a corporation "make the return of income for such corporation in the same manner and form as corporations are required to make such returns." Thus, all of the requirements that law imposed upon petitioner, including the method of tax accounting and the manner of changing that method, applied with equal force to petitioner's trustees. See *United States* v. *Sampsell*, 266 F. 2d 631 (C.A. 9) (basis for property in hands of trustees was bankrupt's adjusted basis and not market value on the date of transfer to the trustee).

---

ested parties and the bankruptcy court to see and act upon. But, the amounts that will in fact be paid out depend on the filing and proof of claims, and the ability of the trustees to reduce receivables to cash or the equivalent. Under the accrual method "deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy." Treasury Regulations on Income Tax (1954 Code), Section 1.446-1(2)(c)(ii). At the time the schedules are filed there is no certainty as to the ultimate amount of the liabilities to be liquidated or the percentage of dividend that will be paid, and that dividend is the limit of the bankrupt's legal liability in the bankruptcy proceedings. Thus there is no accounting basis for treating the trade debts as "accrued" merely because of the filing of schedules with the bankruptcy court. Petitioner notably claims a deduction in the full amount of its trade indebtedness, even though by definition of bankruptcy the full amount was not likely to be paid, and petitioner has apparently made no effort to treat income items by accrual methods.

2. If petitioner remained on a cash basis, the transfer of its assets to the trustees in bankruptcy in and of itself did not liquidate, and therefore did not constitute payment of the petitioner's indebtedness. A trustee in bankruptcy is not, as petitioner would have it (Pet. 5–12, 21–22, 23, 26–30), essentially a collection agent for the creditors. The trustee is an officer of and acts for the court. He must protect the interests of the bankrupt as well as compute the dividends of the creditors. *E.g., Callaghan* v. *Reconstruction Finance Corp.*, 297 U.S. 464, 468: see 2 Remington on Bankruptcy, Section 1117 (1956 ed.). Moreover, at the time the assets were turned over to the trustees, there was no certainty that any set amount would ultimately be used in liquidation of petitioner's debts, for various then undetermined expenses, such as those of administration of the bankrupt estate, take priority over claims of unsecured creditors. Nor was there certainty as to which creditors would file timely and valid proofs of claim, and which assets could be applied in payment.

Therefore, petitioner's transfer of assets placed him in no different position than a taxpayer who transfers assets to another party who assumes, but does not then pay, the taxpayer's business liabilities. Such a transferor cannot deduct the assumed but unpaid liabilities, and neither may petitioner. *Doggett* v. *Commissioner*, 275 F. 2d 823 (C.A. 4); *Citizens Nat. Trust & Savings Bank* v. *Welch*, 119 F. 2d 717 (C.A. 9); *Kniffen* v. *Commissioner*, 39 T.C. 553.

For like reasons there is no merit to petitioner's claim (Pet. 13, 22) that the transfer of its assets was

a deductible loss under Section 165(a) of the 1954 Code. A loss can be deducted only if the taxpayer sustained a specific identifiable loss of assets through a transaction that is closed and completed during the taxable year. See *United States* v. *White Dental Co.*, 274 U.S. 398, 401; Treasury Regulations on Income Tax (1954 Code), Section 1.165–1 (b) and (d) (1). The transfer of assets to a bankruptcy trustee is not a closed or completed transaction evidencing a loss. No loss can occur before the trustee applies the transferred assets in payment of the bankrupt's debts after proofs of claims have been filed and allowed. I.T. 2898, XIV–1 Cum. Bull. 70 (1935).

But even then, there is no logic in finding a loss where a bankrupt receives a discharge of his debts in exchange for his assets. *Stuart* v. *Commissioner*, 38 B.T.A. 1147, should not lead to a contrary conclusion. *Stuart* did allow a loss deduction where a judgment was rendered against a taxpayer, who then filed a voluntary petition in bankruptcy and turned over all his property to the trustee. As the district court correctly noted here (R. 81), "the *Stuart* case is directly contrary to the overwhelming weight of authority on this point". Moreover, three years after *Stuart* was decided the Board of Tax Appeals in *Parkford* v. *Commissioner*, 45 B.T.A. 461, 471–472, affirmed, 133 F. 2d 249, 251 (C.A. 9), certiorari denied, 319 U.S. 741, restricted *Stuart* to its facts and held that there is no deductible loss "when, through the bankruptcy proceedings, he was discharged from liabilities greatly in excess of the actual cost—and basis—of the property which he turned over." 45

B.T.A. at 472. See also, *Cooney* v. *Commissioner*, decided December 22, 1942 (P-H Memo T.C., par. 42,670); *Marlowe* v. *Commissioner*, decided January 27, 1967 (P-H Memo T.C., par. 67012). As the Ninth Circuit stated in affirming *Parkford*, in reasoning equally applicable here, "If [the bankrupt] had voluntarily compromised his [debts] with his creditors by an assignment of his assets he could hardly assert a deductible loss. We perceive no reason why he may do so in the present circumstances." 133 F. 2d at 251.

3. There is no merit to petitioner's final contention (Pet. 13-15, 25-26, 30-36), that the termination of its operations resulted in the loss of usefulness of its packing plant and machinery and entitled it to a loss for obsolescence under Sections 165 and 167 of the 1954 Code. Since the assets were depreciable, any deduction in excess of normal depreciation is governed by Section 167 of the 1954 Code and not by Section 165. See Treasury Regulations on Income Tax (1954 Code), Section 1.165-2.

Section 1.167(a)-8 of the Regulations allows such a "retirement" deduction upon the sale, exchange, or physical abandonment of an asset. In the present case petitioners concede (R. 23) that the packing house and machinery were neither sold nor physically abandoned in the 1959 tax year, but were transferred to the trustees and later sold by them to third parties (R. 23, 31). Thus, petitioner sustained no obsolescence loss that year. See *United California Bank* v. *Commissioner*, 41 T.C. 437, affirmed *per curiam*, 340 F. 2d 320 (C.A. 9); *In re Rae's Estate*, 147 F. 2d 204 (C.A.

3); *Commissioner* v. *McCarthy*, 129 F. 2d 84 (C.A. 7).

Section 1.167(a)–9 of the Regulations entitles a taxpayer to a loss deduction only if there was an abnormal retirement of assets under circumstances whereby they have been damaged by casualty or suddenly became obsolete in the sense of sudden functional or economic uselessness. See *Real Estate Title Co.* v. *United States*, 309 U.S. 13; *United California Bank* v. *Commissioner, supra.* Petitioners have not shown any such loss of usefulness and the trustees' subsequent sale of the packing house and machinery as part of a package sale of petitioner's assets directly refutes the claim of obsolescence.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

CROMBIE J. D. GARRETT,
KARL SCHMEIDLER,
Attorneys.

JULY 1967.

U.S. GOVERNMENT PRINTING OFFICE: 1967

SUPREME COURT, U. S.
FILED
SEP 22 1967
JOHN F. DAVIS, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967

No. 159

B & L FARMS CO., ET AL.,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY TO MEMORANDUM FOR THE UNITED STATES IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

WILLIAM GRESHAM WARD
1240 duPont Building
Miami, Florida
Attorney for Petitioners

E. L. MERDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, HArrison 1-3080

INDEX OF AUTHORITIES

Atkins v. *Wilcox*, (C.C.A. 5) 105 F. 595, 53 L.R.A. 118, 5 Am. B. R. 313 7

B & L Farms Co., et al., as Trustees, etc. v. *United States of America*, 368 F. 2d 571 2

In re Green, etc., United States of America v. *John J. Gaudio*, 264 F. Supp. 849 ..... 5, 8

Maynard v. *Elliott*, 283 U. S. 273, 51 S. Ct. 390 8-9

Nicholas, Trustee v. *United States*, 384 U. S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853 ..... 2, 11

Parkford v. *Commissioner*, 133 F. 2d 249 ..... 12, 13

Real Estate Title Co. v. *United States*, 309 U. S. 13 16

Stuart v. *Commissioner*, 38 B.T.A. 1147 ..... 10, 13

S. S. White Dental Manufacturing Co. v. *United States*, 55 F. Supp. 117 16

United States v. *Bradley*, (C.C.A. 5) 321 F. 2d 224 ..... 3, 5, 8

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967

No. 159

B & L FARMS CO., ET AL.,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY TO MEMORANDUM FOR THE UNITED STATES IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Under the provisions of Rule 23, and in order to point out what we think are erroneous or incorrect statements in the Government's memorandum in opposition, we feel that some reply would be helpful to the Court.

In the first place, we wish to point out that the opinion of the United States Court of Appeals for the Fifth Circuit is now reported in 368 F. 2d 571, and is styled "Memorandum Decision". The Court will note that insofar as the majority opinion was concerned, two of the three Judges on the panel simply had a per curiam affirmance without opinion of the decision of the United States District Court, Southern District of Florida, 238 F. Supp. 407. Circuit Judge John R. Brown wrote a dissenting opinion in which he recommended and found that the lower Court's order was erroneous and should be reversed. On the petition for rehearing the Court mentioned the case of *Nicholas, Trustee,* v. *United States,* 384 U, S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853. The same two Judges denied the petition for rehearing and Circuit Judge John R. Brown again dissented.

In the memorandum of the United States in opposition, beginning on page 1, the memorandum says that the first question raised was whether the arrangement proceeding in Chapter XI, filed on August 1, 1958, required the corporation, which was operating on a cash basis of accounting, to change by operation of law to an accrual basis. The Solicitor General's brief in opposition, on page 4, makes this statement:

> "But even if a change in bookkeeping methods resulted for bankruptcy purposes, a change in tax accounting methods did not automatically follow."

We do not agree with this statement and believe we have demonstrated in the original petition that this is brought about by operation of law. On page 4 of the petition for writ of certiorari the petitioners discussed this proposition and pointed out that the book accounting and auditing arrangements as of August 1, 1958, the date the Chapter XI proceeding was filed, were transferred by op-

eration of law to the accrual basis, and upon passing of the title to all of the assets, first to the Receiver in the Chapter XI proceedings and subsequently to the Trustees in Bankruptcy, in the same fiscal year by operation of law accrued all of those trade accounts. In support of that position we cited the case of *U. S.* v. *Bradley*, C.C.A. 5, 321 F. 2d 224, which in substance held that the provisions of the Internal Revenue Code or the regulations as to technical accounting would be superseded by operation of law under the Bankruptcy Act. We also pointed out on page 5 of the petition that after August 1, 1958, under the receivership in the Chapter XI proceeding additional purchases were made from these trade creditors and that these accounts incurred by virtue of the continued operation had to be classified on the accrual basis. These were debts for value received in and from the various trade creditors, and the accounts were of equal parity to all other accounts and were treated as a lump sum for the creditors.

We pointed out that an arrangement was made in which all of these trade creditors were accrued on the books of the Receiver and that the plan encompassed pro rata payments to all of these creditors. This was in the late fall of 1958, but the operation by the Receiver in Chapter XI proceedings was unsuccessful and bankruptcy resulted on June 26, 1959, within the same fiscal year of August 1, 1958 to July 31, 1959.

The memorandum brief in opposition filed by the Government does not take into account or does not attempt to reply to the authority cited for this statement and position taken by the petitioners. This whole argument of the petitioners is met by the Government, as shown on page 5 of the memorandum, by this statement: "Nothing in the Bankruptcy Act determines the question of the bankrupt's

tax accounting method." The Government does not submit any authority other than that assumed statement.

In the footnote beginning on page 4 of the memorandum the Government claims as follows:

> "It is doubtful in any event that bankruptcy proceedings caused petitioner to use the 'accrual method' that Section 446(c)(2) of the 1954 Code allows for tax accounting purposes. The most that can be said is that a trustee in bankruptcy must schedule accounts receivable and payable for all interested parties and the bankruptcy court to see and act upon. But, the amounts that will in fact be paid out depend on the filing and proof of claims, and the ability of the trustees to reduce receivables to cash or the equivalent. Under the accrual method 'deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.' Petitioner notably claims a deduction in the full amount of its trade indebtedness, even though by definition of bankruptcy the full amount was not likely to be paid, and petitioner has apparently made no effort to treat income items by accrual methods."

This statement, even though in a footnote, does not pretend to meet the real issue, because predicated upon that footnote and the argument on page 5 of the memorandum, the Government then makes this conclusive statement, beginning at the top of page 6:

> "If petitioner remained on a cash basis, the transfer of its assets to the trustees in bankruptcy in and of itself did not liquidate, and therefore did not constitute payment of the petitioner's indebtedness. A trustee in bankruptcy is not, as petitioner would have it, essentially a collection agent for the creditors."

That issue is one that was ignored by the lower Court and was ignored by the majority affirmance in the United States Court of Appeals for the Fifth Circuit.

The respondent, United States of America, concedes that the filing of the Chapter XI proceeding and the subsequent bankruptcy by operation of law matures these debts and requires all of these debts to be listed as accounts payable for equal distribution, or pro rata, according to the class. While making that concession the respondent continues to argue that bankruptcy or a Chapter XI proceeding has no effect upon any of the provisions of the Internal Revenue Code or Regulations.

We have previously pointed out the case of *U. S.* v. *Bradley,* C.C.A. 5, 321 F. 2d 224, but in view of the concessions made by the respondent as to the practical treatment of the creditors at the inception of the Chapter XI proceedings, we think there are several other cases which we have not previously cited that have a direct bearing.

In a recent decision of March 7, 1967, *In re Green, etc., United States of America, Petitioner on Review* v. *John J. Gaudio, Trustee in Bankruptcy,* U. S. District Court, D. Colorado, 264 F. Supp. 849, this same question of the priority or control of bankruptcy provisions over that of the Internal Revenue Code is further discussed, and we quote (see text, p. 851, second column):

> "The Government's contention that this rule should not apply because these taxes were incurred during the pendency of the Chapter 11 proceedings and the receivership, in our opinion, is without merit. It appears clear to us that the second sentence of § 7501(a) means that the trust fund mentioned in the first sentence is nevertheless subject to the provisions of § 64(a) of the Bankruptcy Act which establishes a priority for all expenses of administration including taxes. So

construed there is no conflict between § 7501(a) and § 64(a) of the Bankruptcy Act.

If, however, there is a conflict between § 7501(a) and § 64(a) of the Bankruptcy Act, we conclude that § 64(a) should prevail. In Guarantee Title & Trust Co. v. Title Guaranty & Surety Co., 224 U. S. 152, 32 S. Ct. 457, 56 L. Ed. 706 (1912) it was held that § 64 of the Bankruptcy Act prevailed over a general statute (Revised Statutes § 3466) which provided that in case of insolvency of one indebted to the United States, the debts due the United States shall be first satisfied and that this priority of the United States shall extend to cases in which an act of bankruptcy is committed.

In Davis v. Pringle, 268 U. S. 315, 45 S. Ct. 549, 69 L. Ed. 974 (1925) the Supreme Court approved Guarantee Title & Trust Co., supra, and again held that § 64 of the Bankruptcy Act prevailed over the priority of the United States provided in § 3466 of the Revised Statutes.

More recently, the Supreme Court has referred to the policy which led to the establishment by § 64(a)(1) of the Bankruptcy Act of priorities that place all expense of administration on a priority, including claims for taxes as a 'strong policy.' Nicholas v. United States, 384 U. S. 678 at 691, 86 S. Ct. 1674, 16 L. Ed. 2d 853(1966).

The Court in Guarantee T tle & Trust Co., supra, denominated the policy as 'beneficent.'

We can read into § 7501(a) no Congressional intent to repeal, revise or modify its 'strong' and 'beneficent' policy of subjecting the Government's tax claims to the priorities established by § 64(a) of the Bankruptcy Act."

This law has been completely ignored by the respondent. The bankruptcy law is supreme when it forces the debtor to file schedules and forces the trustee to recognize

all accounts, whether paid or not paid, on an accrual basis. The bankruptcy law, therefore, requires the change of the accounting method from a cash to an accrual basis, and if this should result in a conflict between the bankruptcy provisions and the Internal Revenue Code provisions, bankruptcy prevails. These accounts were accrued by operation of law from and after August 1, 1958, and when bankruptcy ensued on June 26, 1959 and all of the assets were transferred by operation of law to the trustee for the benefit of distribution to creditors, then payment had been made.

In the dissenting opinion of Circuit Judge Brown it was specifically pointed out that under Section 70(a) of the Bankruptcy Act, 11 U.S.C.A., § 110a, the trustee is vested by operation of law as of the date of bankruptcy with title to all of the non-exempt property of a bankrupt. Since the Bankruptcy Act of 1867 the Congress has recognized that insolvent estates are trusts of which the creditors are the beneficiaries, and Judge Brown points specifically to Section 44 of the Bankruptcy Act, 11 U.S.C.A., § 72, 2 Collier on Bankruptcy, ¶ 44.01. Judge Brown further pointed out that as of that date all of the assets of the bankrupt passed to the trustee and the costs of Court have to be borne by the trustee and the creditors rather than to be paid for out of general appropriations from tax funds. This opinion by Judge Brown was supported by his reference to the case of *Atkins* v. *Wilcox*, 5 Cir., 105 F. 595, 53 L. R. A. 118, 5 Am. B. R. 313. In that opinion of December 18, 1900, the Circuit Court of Appeals, Fifth Circuit, established this as the law even under the Bankruptcy Act of 1898:

> "Under Bankr. Act 1898, a trustee of a bankrupt is authorized, as representative of all the creditors, to contest the allowance of any claim filed against the estate."

It is from the language in this case, which so far as we know has never been changed in any reported decision, that Judge Brown concludes:

> "At the instant of bankruptcy the title to the assets vest in the Trustee, in trust for the creditors, pro rata according to the debts held by them as of that same instant. True, at that instant no creditor is entitled to receive, or to demand, from the Trustee any sum certain. The exact amount each creditor will receive must await the converting of the property to cash and the payment of the costs. But mere postponement of enjoyment has never been held to disqualify an interest as 'property.'
>
> As the District Court has observed, payment in cash or its equivalent has long been recognized. The transfer by operation of law of the assets of the bankrupt amounted to exactly that."

The fact that Judge Brown did not refer to these additional supporting decisions which were contained in the opinion in *In re Green, United States etc.* v. *John J. Gaudio,* 264 F. Supp. 849, does not weaken his opinion. We have submitted the above opinion to show that Judge Brown's conclusions were not only supported by this case and the case of *United States* v. *Bradley, supra,* but were amply supported by the other decisions above mentioned.

Counsel for the Government so answered to that position, as contained on page 7 of the memorandum, as follows:

> "The transfer of assets to a bankruptcy trustee is not a closed or completed transaction evidencing a loss. No loss can occur before the trustee applies the transferred assets in payment of the bankrupt's debts after proofs of claims have been filed and allowed."

This statement is contrary to the direct holding by this Court in the case of *Maynard* v. *Elliott,* 283 U. S. 273, 51 S.

Ct. 390. In speaking of the effect of bankruptcy in the construction of what was then Section 63 of the Bankruptcy Act, this Court said (see text, first column, p. 392, 51 S. Ct.):

> "Possible doubts as to the meaning of the section should be resolved in the light of the purpose of the Act 'to convert the assets of the bankrupt into cash for distribution among creditors, and then to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.' Williams v. U. S. Fidelity Co., supra, page 554 of 236 U. S., 35 S. Ct. 289, 290; Central Trust Co. v. Chicago Auditorium, supra, page 591 of 240 U. S., 36 S. Ct. 412. If this purpose be given its appropriate weight, a meaning cannot be attributed to the plain words of subdivision (a) (4), which would so restrict them as to preclude proof of claim upon the liability of an indorser of commercial paper, and result in its survival of the bankrupt's discharge as an obligation enforceable against him.
>
> That some contingent claims are deemed not provable does not militate against this conclusion. The contingency of the bankrupt's obligation may be such as to render any claim upon it incapable of proof. It may be one beyond the control of the creditor, and dependent upon an event so fortuitous as to make it uncertain whether liability will ever attach."

Counsel for the Government has overlooked that as a part of the assets turned over on July 26, 1959 to the new trustees in bankruptcy there was a sum slightly in excess of $200,000.00 in cash. The pretrial statements and stipulations heretofore mentioned clearly showed the amount and value of the other property which, although not liquidated immediately upon the date of bankruptcy, had a fair market value in cash or its equivalent, as stipulated by the respondent. We respectfully say that the conclusion or assumption of the respondent as above set forth is entirely without foundation.

Counsel for the respondent admits that the case of *Stuart* v. *Commissioner*, 38 B.T.A. 1147, was based upon similar facts as the petitioners are now contending, and that the Board of Tax Appeals in that case held that when a petition in bankruptcy had been filed and an adjudication entered and the debtor had turned over all of his property to the trustee, there was a payment.

We will not further burden this Court with again answering the next contention of the Government when, as shown on page 7 of the memorandum, the Government says that the statement of the District Court was correct insofar as the District Judge stated that the Stuart case was directly contrary to the overwhelming weight of authority on this point. We have taken the direct position that there is no decision which could be construed as changing the doctrine of the Stuart case and that there is no overwhelming weight of authority on that point, and as a matter of fact there is no contrary authority. We have covered that point in the petition for certiorari on pages 7, 8 and 9.

We wish to point out again for emphasis that, as set forth on page 9 of the petition for certiorari, the passing of the title and possession to the trustee was not a contingent payment and it was not a substitute type of payment, but it was a direct payment, unconditional and subject only to the time which it took in the Bankruptcy Court to make ultimate distribution to the creditors. There is no opening for the Government to contend that it was uncertain as to what the loss was, because that was all covered in the pretrial stipulations, beginning at page 20 of the Record, and the supplemental pretrial stipulation, beginning at page 29 of the Record.

If there has ever been any doubt in the federal law on this subject—which we do not admit—certainly the

ruling of this Court in *Nicholas* v. *United States*, 384 U. S. 678, 86 S. Ct. 1674, decided June 13, 1966, cleared up any ambiguity. This case was not available at the time of the trial in the lower Court, nor was it available when the briefs were filed on the appeal to the United States Court of Appeals, Fifth Circuit. However, it was squarely raised in the petition for rehearing, which is shown as a part of the certified record sent from the United States Court of Appeals, Fifth Circuit, and is covered in the certificate of counsel for petitioners.

This Court, as shown by that part of the opinion in 86 S. Ct. 1674, second column, page 1679, said:

> "We believe that the decisions of this Court in *Sexton* and *Saper*, reflect the broad equitable principle that creditors should not be disadvantaged vis-a-vis one another by legal delays attributable solely to the time-consuming procedures inherent in the administration of the bankruptcy laws."

In footnote 11 reference is made to the Sexton case and the Court quoted the Sexton case with approval that on the filing and adjudication of bankruptcy that date fixes the moment when the affairs of the bankrupt are supposed to be wound up. Under this doctrine it is theoretically possible where there was a simple bankruptcy to liquidate and pay the creditors on the same day. As Judge Brown pointed out and as this Court has pointed out, the fact that that is not possible because of the procedure in the bankruptcy case, the creditors should not be put to a disadvantage. It is true that the creditors pay the costs of administration out of their portion and no further charge is made to the bankrupt, nor is any further charge supposed to be made from the public at large or from tax funds.

June 26, 1959, a period well within the current fiscal tax year, terminated the relationships directly between the debtor and its creditors. Everything that could be accomplished so far as the debtor was concerned was accomplished, when on that day all of its assets were turned over to the trustee by operation of law under Section 70. As of that time on it was a matter of simple detail in the amounts that were paid as of that moment, subject to determination. As we have above stated and we wish to reiterate, the amounts of the losses—the exact figures—are not here subject to review, because it was all stipulated to, as shown by the pretrial conferences and stipulations heretofore referred to.

We do not have any expression in the opinion or any logical reasoning or cases cited by the majority opinion of the United States Court of Appeals, Fifth Circuit. Thus we are not favored with any citation of authorities, with the exception that two of the three Judges on the panel by per curiam decision affirmed the judgment of the lower Court. We do not have any argument now in the memorandum in opposition to show whether or not Judge Brown in his dissenting opinion was wrong. We do not have anything in the memorandum in opposition from respondent's counsel wherein the Solicitor General of the United States makes the contention that the Stuart case is directly contrary to the overwhelming weight of authority on this point, with the bare exception that the Solicitor General contends that the District Judge was correct when he made that comment.

We have thoroughly discussed the questions involved in the *Parkford* v. *Commissioner* case, 133 F. 2d 249, 251, at pages 7, 8 and 25 of the petition for certiorari, and in particular, on page 8 of said petition, the petitioners elaborated that the facts in the Parkford case were not

in the least applicable to the same points involved in the Stuart case. Actually the opinion by the Ninth Circuit in that case did not depart from the rule of the Stuart case, and the United States District Judge, as well as the majority opinion of the United States Court of Appeals for the Fifth Circuit, erred in so construing that case. So far as we can tell the *Parkford* v. *Commissioner* case is the only basis for the holding by the lower Court that the doctrine of the Stuart case was contrary to the overwhelming weight of authority on this point. That case is not even authority on that point and certainly could not constitute the overwhelming weight of authority on the points raised and decided in the Stuart case.

SUMMARY AND CONCLUSION

The opposition of the respondent, United States of America, to the granting of certiorari is based on the contention:

> "The result below is in accord with the settled state of the law, and there is no occasion for further review." (Memo. p. 2).

The petition for certiorari makes out a case to the contrary and respondent's memorandum adds confirmation thereto.

The only bankruptcy case found to date involving deductible debts existing at the time of bankruptcy is *Stuart* v. *Commissioner*, 38 B.T.A. 1147. We have pointed out that *Parkford* v. *Commissioner*, 45 B.T.A. 461, relied on by respondent, did not involve deductible debts at the time of bankruptcy. These cases certainly did not settle the law favorable to respondent as to the effect of bankruptcy on the time a deduction may be taken by a cash basis taxpayer on account of previously incurred deductible debts.

The non-bankruptcy cases relied upon as weight of authority in opposition to the Stuart case are the commonly referred to "constructive payment" cases. Respondent contends (Memo. p. 6):

> "petitioner's transfer of assets placed him in no different position than a taxpayer who transfers assets to another party who assumes, but does not then pay, the taxpayer's business liabilities. Such a transferor cannot deduct the assumed but unpaid liabilities, and neither may petitioner." (Citing cases relied on).

The difference between a voluntary transfer of assets to a third party who assumes the indebtedness and a transfer of assets to a trustee in bankruptcy is clear. In the case of such voluntary transfer of assets the creditor is not a party bound by the transaction and may still enforce his claim against the debtor by Court action or otherwise; whereas, in the case of bankruptcy the creditor is a party bound by the transfer and proceedings and can no longer enforce his debt by Court action against the debtor, or even further negotiate with him for settlement of his claim.

Upon adjudication in bankruptcy the debtor is compelled to pay his money and assets over to the trustee in bankruptcy and he is finished. He no longer has any control over those assets and the distribution thereof to his creditors. Thereafter the trustee in bankruptcy becomes the representative of the creditors in the liquidation and distribution of such assets and they are bound by all lawful proceedings taken by their trustee in their behalf.

Payment may be made directly to a creditor or to a person authorized by law to receive payments. After bankruptcy the debtor is prohibited from making payment with any of his assets directly to a creditor; the trustee in bankruptcy is the only person authorized by law to receive payment of his assets.

Respondent's contention that the debtor should be barred from his deduction because the exact amount of payment later to be enjoyed by his trade creditors was not known at the time of adjudication in bankruptcy is not well founded. The amount of cash paid to the trustees was known; the value of other assets paid to the trustees could be determined by appraisal; the amount of trade creditors entitled to participate in the distribution of such assets was known, and stipulated to. The fact that the creditors must bear the burden of administrative costs out of the fund (which may also be deductible) should not lessen or postpone the deduction. For example, a creditor may be burdened with attorneys' fees in collecting a debt, but this does not lessen the debtor's deduction.

The fallacy of the Government's defense is well illustrated on page 8 of the memorandum in opposition:

> "As the Ninth Circuit stated in affirming *Parkford*, in reasoning equally applicable here, 'If (the bankrupt) had voluntarily compromised his (debts) with his creditors by an assignment of his assets he could hardly assert a deductible loss. We perceive no reason why he may do so in the present circumstances.' 133 F.2d at 251."

In our case respondent in all honesty must concede that if the debtor (bankrupt) had voluntarily compromised its debts with its trade creditors by assignment of its assets to them it could have taken the deduction in the year of the transaction. We perceive no reason why it may not do so where in bankruptcy it has been finally and irretrievably divested of its assets to pay its debts. (See statement to like effect in Stuart case, Pet. App. A-15)

At least one issue between petitioners and respondent as to the loss on account of the packing house seems clear. Respondent asserts:

> "Since the assets were depreciable, any deduction in excess of normal depreciation is governed by Section 167 of the 1954 Code and not by Section 165." (Memo. p. 8)

Petitioners claim the loss under Section 165. It is true that after the year in which petitioners' loss was claimed Regulation 1.167(a)(8) was adopted to replace Regulation 39.23(e) which was in effect for many years, but it will be noted that Regulation 1.165-2 effecting this change specifically makes Regulation 1.167(a)(8) applicable to losses allowed under Section 165 of the Code.

The restrictive interpretation of this Court in *Real Estate Title Co.* v. *United States*, 309 U. S. 13, limiting obsolescence losses claimed under the depreciation statute (now Section 167 of the 1954 Code) to functional causes has never been applied to sudden obsolescence losses allowed under the loss statute (now Section 165 of the 1954 Code) (see *S. S. White Dental Manufacturing Co.* v. *United States*, 55 F. Supp. 117). The cause of the loss was the forced discontinuance of its business. This point has been fully presented by petitioners in the lower Court by petition for rehearing, and in this Court by petition for writ of certiorari. While respondent has not replied to this argument, inferentially it does appear that respondent may contend that Regulation 1.167(a)(8) retroactively repealed the allowance of the deduction authorized under Section 165 upon discontinuance of business, but the respondent refuses to squarely meet the issue.

We believe that the petition for writ of certiorari and respondent's memorandum in opposition demonstrate the unsettled and confused status of the law as to when an

admitted loss on account of depreciable property is deductible, and the need of clarification by this Court.

Respectfully submitted,

WILLIAM GRESHAM WARD
1240 duPont Building
Miami, Florida 33131
Attorney for Petitioners

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing Reply to Memorandum for the United States in Opposition to Petition for Writ of Certiorari has been mailed this ..... day of September, 1967, to the Hon. William A. Meadows, Jr., United States Attorney, P. O. Box 1070, Post Office Building, Miami, Florida, and Hon. Thurgood Marshall, Solicitor General, Hon. Mitchell Rogovin, Assistant Attorney General, Hon. Crombie J. D. Garrett and Hon. Karl Schmeidler, Attorneys, Department of Justice, Washington, D. C. 20530.

WILLIAM GRESHAM WARD